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FIRST CONCURRENT RESOLUTION ON THE BUDGET—FISCAL YEAR 1985

HEARINGS

BEFORE THE

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

SECOND SESSION

ECONOMICS

FEBRUARY 2, 1984 } VIEWS OF THE REAGAN ADMINISTRATION
FEBRUARY 3, 1984 }

FEBRUARY 8, 1984—VIEWS OF THE CONGRESSIONAL BUDGET OFFICE

FEBRUARY 29, 1984—VIEWS OF THE FEDERAL RESERVE SYSTEM

FEBRUARY 7, 1984 }
FEBRUARY 9, 1984 } VIEWS OF OUTSIDE ECONOMISTS
FEBRUARY 29, 1984 }

Volume I

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VIEWS OF THE REAGAN ADMINISTRATION

THURSDAY, FEBRUARY 2, 1984

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Armstrong, Kassebaum, Boschwitz, Andrews, Symms, Grassley, Kasten, Quayle, Gorton, Chiles, Biden, Johnston, Sasser, Metzenbaum, Riegle, and Exon.

Staff present: Stephen Bell, staff director; and Gail Fosler, chief economist.

For the minority: Richard N. Brandon, staff director; and Garry Schinasi, senior economist for macroeconomics and fiscal policy.

Chairman DOMENICI. Good morning. Could we have a little order, please?

First, let me apologize to the members of the committee and others who were here promptly at 9:30, and let me give you some justification for the delay. This morning was the National Prayer Breakfast, Senator Metzenbaum. There were thousands of people there, and most Members of the Cabinet, and many Members of the National Legislature, and I thought that it might be more efficacious if we prayed about this budget, rather than start the hearing early.

Senator METZENBAUM. They need it.

Chairman DOMENICI. In fact, we prayed for David Stockman.

Senator METZENBAUM. He particularly needs it.

Senator ANDREWS. Would it be better if Mr. Stockman prayed for us?

Chairman DOMENICI. Well, he did, too. But he did tell me as he came in, that he thought that perhaps a half hour would be better used praying than talking here, but nonetheless we will proceed, and we will do so in the future as much on time as possible.

Senator Chiles, you were also there. I do not know how you beat me back. I even left early, and did not make it back on time. That means that I cannot even find my way around Washington.

OPENING STATEMENT OF CHAIRMAN DOMENICI

It is a pleasure to welcome you to this committee, Mr. Stockman. By now you know this committee pretty well. By the end of this year, you will be the longest running OMB Director since Harold Smith who served under Franklin Delano Roosevelt during World War II. In some businesses, this would be concidered box-office success. As you well know, in this budget business, it just means that you have larger and more difficult problems to solve. You have been as right as anyone about the numbers and the seriousness of our deficit problem, and I commend you for staying on year after year to work with us to find solutions.

Mr. Stockman, I am going to start right up front by saying something that everyone in this room knows. This is an election year. This is not only a congressional election year. This is a Presidential election year.

TASK AHEAD HAS MANY DETRACTIONS

It is an environment ripe for political hyperbole. For example, I hear from some that the economy, indeed America, is worse off than at any time in its history. That's simply not true. This past year employment growth matched the 1978 peak and the unemployment rate dropped more dramatically than in any one year in the entire postwar period. People are more optimistic about their economic future than at any time since the early 1970's.

I hear that this President has devastated the Federal budget by slashing taxes. And yet we know that the tax burden is still well above the levels of the 1960's and the early 1970's.

I hear that our Nation's trade deficit is going to sink this recovery. And that this deficit is due to high budget deficits and the high value of the dollar. But when I look at the data, I see that it is imports that are the culprit—not the loss in exports. Our trade problem is the result of the high real income levels in this country that help our people purcahse goods from abroad. We are the world's market and, in a world struggling for economic survival, these disturbing trade numbers may be a necessary lifeline.

Finally, I hear that the President is cruel, unfair, and has cut too much spending from social welfare programs. Yet, programs to feed poor people, like food stamps and child nutrition, have increased by about 41 percent since 1980. SSI benefits for needy aged, blind, and disabled persons have increased by 32 percent per person. Medicaid expenditures to help keep needy people healthy have increased by 44 percent since 1980. If these are cuts, maybe I can't add.

I hear these things. We will all hear them again and again before next November. But I tell you, Mr. Stockman, they detract from the task at hand.

We, on this committee, have a job to do—and it is to devise a budget. It is going to be a difficult job. No one is going to be perfectly satisfied with the outcome. But the President has given us an opportunity to get the job done. Now, we have to take him up on his offer.

In his state of the Union message the President called upon Congress to join with him in a bipartisan effort to enact what he called a down payment on future deficit reduction actions. This is an extraordinary attempt by a President to create an environment for action—an environment to get broad agreement on what needs to be done and what can be done in this difficult election year.

The President's budget is a blueprint for such action. The President has proposed significant deficit reduction actions in the years fiscal year 1985 through fiscal year year 1987. The President's budget proposes spending reductions totaling $72.4 billion over the 3 years—fiscal year 1985 through fiscal year 1987. The President's budget proposes spending reductions totaling $72.4 billion over the 3 years—fiscal 1985 through fiscal 1987 and revenue increases, in the form of structural tax reform, totaling $33.7 billion over the 3 years. This means that the President's own budget proposes larger deficit reductions, $106 billion over the 3 years, than the down payment the President has asked Congress to enact.

Now, there will be many who will call the President's proposals inadequate. But, we have to ask by what standard? The revenue increase in the President's budget is 50 percent larger than the revenue portion of the Omnibus Reconciliation Act which neither House, so far, has seen fit to pass. The spending reductions are almost half as large as the spending reductions this Congress enacted in the historic 1981 reconciliation bill—and for which we all took great credit.

THIS YEAR'S INCREASES FOR NATIONAL DEFENSE ARE TOO HIGH

In two other areas, I think we should start this year's deliberations from a factual basis based on history. First, as I read it, the President has requested an increase of 13 percent real growth for function 050, national defense. During the past 3 years, the Congress has approved spending for national defense of $750 billion, in round terms. The President has won, according to my calculations, about 95.4 percent of the defense spending levels he has requested. Now, in anybody's book, that is truly an excellent record for both the President and the Congress. Therefore, it's my initial observation that this year's increases for national defense are too high. I will work with the administration on some compromise in this area and, frankly, I would hope that when all is said and done, and an appropriations bill for defense is sent to the President, we could send him a level close to the levels now contained in the budget resolution.

Second, I must bring some historical perspective to overall spending. The President, as I just pointed out, has been wildly successful in getting his defense increase. And, believe it or not, he has been successful in getting the restraint in the overall Federal budget that he has requested. Many economists, including Nobel Prize winner Milton Friedman, contend that it is the overall total of Federal spending in the Nation's economy that is the important measure of Government intrusion or influence. By that measure, we are doing well. For example, in fiscal year 1984, the Congress approved a budget resolution that foresaw spending for the years 1984–86 of $2.719 trillion. The President's request for those 3 years, based upon his April update of his original budget request, was total spending of $2.749 trillion. Thus, Congress budget would have actually called for less spending during the next 3 years than the President's request.

In light of the fact that the President has been so successful in getting his defense increases, and that Congress has gone along with his spending restraint, one is allowed to ask why we have such large deficits. Simply, the vast majority of the deficit increases we now face comes from the severe recession we endured. It is folly to think that we can, in 1 year or even 3 years, remove from the books the impact of that recession. Anyone who says we can, without important and perhaps unexpectedly unpleasant consequences for our economy, is misreading the past and misinterpreting the present.

The deficit problem is large and growing. Early action is important. The realization of a smaller action today is more important than the promise of a larger action tomorrow.

So, Mr. Stockman, if there is any doubt, I believe that this committee is ready to begin to do its work. And I look forward to your testimony this morning on the President's own proposals as well as other proposals that you believe would receive serious consideration.

I am now going to yield to Senator Chiles, hopefully everyone here will have a chance to interrogate Mr. Stockman to the fullest during his appearance here today.

Senator **Chiles**. Mr. Chairman, this is our opening meeting, and as you know, while we have tried to have an unwritten ground rule that opening statements would be confined I do find that I have members on our side this morning that would like to have a few minutes, and I just wanted to mention that to you at the outset.

Chairman **Domenici**. All right. We will try to accommodate you.

OPENING STATEMENT OF SENATOR CHILES

Senator **Chiles**. Thank you, Mr. Chairman.

Good morning, Mr. Stockman. It is always a pleasure to have you here. At least it is a pleasure for us.

SOMETHING HAPPENED TO COMMONSENSE BUDGETING

I remember listening to the State of the Union Address last week, and especially to the part where the President called for commonsense budgeting, the kind that avoids spending more money than we take in. Something has happened in the week between the address, and the presentation of the budget we now see, because we are looking at $180 billion, and while I have normally felt that budget proposals should be an agenda for action, a proposed set of solutions to our problems, I find that this one seems to be more of a "hold-the-course," election year budget as the chairman pointed out.

I think as we look through the budget we do find some interesting departures from earlier White House policies. For example, we notice that the operating funds for the Environmental Protection Agency climb 8.5 percent in the 1985 budget. That's a reversal of the policy from 1981 to 1984 where the real funding for EPA dropped 44 percent, and the staff was reduced by 20 percent. That's a little like Secretary Weinberger saying give us the money up front and we'll ask for less later. Only in reverse.

The fiscal 1985 budget contains $1.875 billion for low-income energy assistance, but the fiscal year 1984 budget proposed a $1.3 billion cut. We see that while the administration opposed criminal justice assistance programs in 1983, we now find a new program for that purpose in this year's budget.

There are a few examples of switches and reversals scattered through this year's budget, examples of how election year notions can adjust the perspective of the President.

I do not think we should lose sight of the fact that Federal elections are always, this year, or the next. So it is really a matter of either we get the deficits this year or the deficits are going to get us this year or the year after.

ECONOMIC ASSUMPTIONS STIR SKEPTICISM

I want to focus briefly this morning on a few key features of the budget, beginning with the economic assumptions. The real problem appears as you look down the path between now and 1989. The budget expects average real GNP growth of four percent during that period, but most forecasters are suggesting that it will be around 3.5 percent.

The administration expects unemployment to fall to 5.7 percent by 1989, but the conventional forecasters doubt it is going to go below 6.5 percent. And while the White House predicts the T-bill rate to come down to 5 percent, most forecasters look to 1989 with a T-bill rate of near 8 percent.

The figures prepared by our staff, the minority staff of the Budget Committee, indicate that if the real growth in GNP averages one-half percent lower than expected over the next 5 years, then Treasury bills could well come in at 7.8 percent. And we will be adding between $125 to $150 billion to the deficit by 1989. I do not know if these are consistent with your own figures.

I am skeptical about the out-year economic assumptions built into this budget. I do not think we can reach the goals that the budget proposed, based on the lack of deficit reduction the budget proposes.

COMPREHENSIVE PLAN OF ACTION NEEDED

What we need, and what I hope will come out of the budget summit conference between the White House and the Congress, is the comprehensive plan of action that reaches all parts of the budget. We cannot lay down the ground rules and say that we can cut back certain parts of the budget but not others. We need to have everything on the table, including military spending and tax revenue.

I am worried about our capacity to operate a military of the size projected in your budget. It seems that we lose sight of the fact that the military buildup started in the late seventies, and the costs have been large and growing much larger.

To put those costs in perspective, if we fund the military in 1989 at the 6.4 percent level of GNP that it is at right now, it is going to cost $344 billion. The President's request would cost $409 billion by 1989, and so we would have to collect $200 billion in new taxes by 1989, just to keep the structural deficit the same. Or, if we do not collect those taxes, we are adding $290 billion to the bottom line of that deficit. That would work out to either a 12 percent charge on individual tax liabilities, if we were going to tax it, or 66 percent on corporate tax liability by 1989.

With all that, there are still no new revenues in the budget. I really have to ask how you plan to pay the freight. How do you plan to cut the deficit?

Frankly, Mr. Stockman, I suspect that you are not entirely comfortable with this budget. And I do not have much faith in a line item veto as a way to repair it, especially when you already missed the main chance to cut the deficit, and that is in the President's budget.

BUDGET PACKAGE IS ESSENTIAL

I read your interview with Fortune, and it sounds to me like you came out with your hands up. You did not seem to think there was much more money to be saved by cutting waste, fraud and abuse. You pointed out that most of those stones have been turned over, and you thought defense spending had a certain inevitability to it. You acknowledged domestic spending had been contained, and when you suggested medicare might become a political football, I did not believe it until I examined your budget, and found you had decided to punt.

Could it be that you are——

Chairman Domenici. Field goal.

Senator Chiles. Field goal? You get three points for that. I did not see any points in this budget.

Could it be that you were telling Fortune what some of us have been saying, that a budget package is essential, and it cannot avoid new revenues as one of its features?

Everyone in this room knows that Federal deficits are the principal threat to the economy. The voters know it, too. I do not think they are willing to put up with a budget that is a concession to old politics which says hard issues cannot be faced squarely in an election year.

I think we have to face those issues, and of course we cannot do it by going our separate ways.

As the budget discussions began, I want you to understand that there are a number of us that are willing to join in a good faith effort to cut the deficits. I have particular views, but they are subject to revision, if the President is willing to negotiate, too. But many of us want to see deeds and actions with realistic economics as the starting point.

I am not trying to pin a tax increase on the President, but if you are really going to get some work done there is not much point in the President trying to pin a deficit on the Congress. We both have to work on these problems mindful that both spending and taxes are at fault.

We are in a fix with these deficits, and this morning the committee would like your personal thoughts, as candidly as you would give them to a magazine, on what you think must be done to cut that deficit. We will appreciate your help.

[The prepared statement of Senator Chiles follows:]

Senator **Lawton Chiles**

Florida

Senate Budget Committee, Room 634, Dirksen, Washington D.C. 20510 **202-224-8695**

Contact: Dennis Beal

RELEASE ON DELIVERY
February 2, 1984

Remarks of
Senator Lawton Chiles
at the
Senate Budget Committee Hearing
with
David Stockman
February 2, 1984

Good morning, Mr. Stockman. It's always a pleasure to have you here. At least it's a pleasure for us.

I remember listening to the State of the Union Address, and the part where the President called for "common sense budgeting" -- the kind that avoids spending more money than we take in. But in the week between that speech and the release of the budget, he evidently changed his mind.

I've always felt a budget should be an agenda for action, a set of proposed solutions to our problems. I really don't see that in Fiscal 1985. What I do see is a $180 billion deficit, and some election-year tinkering.

When you look through the budget you find some interesting departures from earlier White House policies. For example, I notice operating funds for the Environmental Protection Agency climb 8.5 percent in the 1985 budget. That's a reversal of the policy during 1981 to 1984 when real funding for EPA dropped 44 percent, and staff was reduced by better than 20 percent.

The Fiscal 1985 budget contains $1.875 billion for low-income energy assistance. The FY 1984 budget proposed $1.3 billion.

And although the Administration opposed criminal justice assistance program in Fiscal 1983, we find a new program for that purpose in this year's budget.

These are a few examples of switches and reversals scattered throughout this year's budget. And they are examples of how election year notions can adjust the perspective of the White House.

But we should not lose sight of the fact that federal elections are always this year or the year after. It's really a matter, then, of either we get the deficits this year -- or the deficits get us this year or the year after.

I want to focus briefly this morning on just a few key features of the budget, beginning with the economic assumptions. The real problems appear as you look down the path between now and 1989. The budget expects average real growth in GNP of 4 percent during that period, but most forecasters expect it to be around 3.5 percent.

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Figures prepared by the minority staff of the Senate Budget Committee indicate that if real growth in GNP averages one-half percent lower than expected over the next five years, we will be adding between $125-150 billion to the deficit in 1989.

I'm very skeptical about the out-year economic assumptions built into this budget. I just don't think we can reach the goals the budget proposes, based on its lack of deficit reduction.

What we need -- and what I hope will come out of the budget summit between the White House and the Congress -- is a comprehensive plan of action that reaches all parts of the budget. We cannot lay down ground rules that say we can cut hold back cuts in certain parts of the budget, but not others. We need to have everything on the table, including military spending.

I'm worried about our capacity to actually operate a military of the size projected in your budget. It seems to me we lose site of the fact that the military buildup has been underway now since the late 1970's. And the costs have been large and are growing even larger.

Let me put those costs in perspective. If we were to fund the military in 1989 at the 6.4 percent level of GNP it's at right now, it would cost $344 billion. But the President's request would cost $409.1 billion by 1989. We would have to collect $202 billion more in taxes by 1989 just to keep military spending in the budget from increasing the deficit. It would work out to either a 12 percent charge on individual tax liabilities or 66 percent on corporate tax liability by 1989.

With all that, there are still no new revenues in this budget. So I really have to ask how you plan to pay the freight? How do you plan to cut the deficit?

Frankly, Mr. Stockman, I suspect you're not really comfortable with this budget. And I don't have much faith that a line item veto is the way to repair it, especially when you have already missed you main chance to cut the deficit -- the President's budget.

I read your interview with Fortune, and it sounds to me like you came out with your hands up. You didn't seem to think there was much more money to be saved by cutting waste, fraud and abuse. You said most stones had already been turned over.

You thought defense spending had a certain inevitability to it. You acknowledged domestic spending has been contained. And when you suggested Medicare might become a political football, I didn't believe it until I examined the budget and found you had punted on Medicare.

Could it be you were telling Fortune what I've been saying? That a budget package is essential and it cannot avoid new revenues as one of its features?

Everyone in this room knows that federal deficits are the principal threat to the economy. And the voters know it, too. I don't think they are willing to put up with a budget that's a concession to the old politics that says hard issues can't be faced squarely in an election year.

We've got to face these issues. And, of course, we can't do it by going our separate ways. As the budget summit begins, I want you to understand I'm willing to join in a good-faith effort to cut the deficits. I have particular views, but they are subject to revision -- if the President is willing to negotiate, too. I want to see deeds and actions with realistic economics as the starting point.

I'm not trying to pin a tax increase on the President, but if we are really going to get some work done, there's not much point in the President trying to pin the deficits on Congress. We've both got to work out the problems, mindful that both spending and taxes are at fault.

We are in a fix with these deficits, and this morning the committee would like to have your personal thoughts -- as candidly as you would give them to a magazine -- on what YOU think must be done to cut the deficit.

We would appreciate your help.

Chairman **Domenici**. Thank you very much, Senator Chiles.

I may have made an erroneous statement in assuming that everyone was going to get ample opportunity for questions today. I am going to try to accommodate everyone. Mr. Stockman, how long can you be with the committee? Can you be here through lunch?

Mr. **Stockman**. Yes.

Chairman **Domenici**. 12:30 or so?

Mr. **Stockman**. As long as necessary.

Chairman **Domenici**. All right.

As I understand it, some of the Senators on your side, Senator Chiles, desire to make brief opening remarks.

Senator **Chiles**. Yes, sir.

Chairman **Domenici**. This is in addition to their normal questioning sequence.

Do any on our side desire that?

All right, you reserve the right to rebut, I assume.

Senator Metzenbaum, you would like 3 to 5 minutes? Can we go with 3?

Senator **Metzenbaum**. Five.

Chairman **Domenici**. We will make it 4.

Go ahead, Senator.

OPENING STATEMENT OF SENATOR METZENBAUM

Senator **Metzenbaum**. First, Mr. Chairman, this ought to be charged against my time.

I want to commend you and Senator Dole, Senator Chiles for continuing to make your voice heard on this whole question of the need to work out a program to balance the budget, and I think you have tried hard. And I want to say that I doff my hat to you for that effort.

PRESIDENT'S PROGRAM NOT GOING TO SOLVE PROBLEM

I think it is particularly important because we learned today that the President's program is not going to solve the problem. We find that Government is about to borrow $193 billion this year, we find that the investment bankers are saying that we will crowd out worthwhile investment that would otherwise be available and we know that as we meet here this morning that the market is down to a 5-month low, it is at 1,212, and that has normally been a precursor of what we can expect in the economy when the market goes down, somehow the rest of the economy seems to follow and unemployment occurs and market, general economic conditions get bad.

Now, Ronald Reagan, back in September [illegible] was the man who said that the administration is committed to a balanced budget and that he would fight to the last straw to achieve it by 1984. Mr. President, we are at that point. Ronald Reagan, in May of last year, attempted to put the blame on us in the Congress, and speaking to the homebuilders and referring to Congress, he said "they have got a credit card that has run out of credit and are asking the American people to raise the limit. We must answer with one word," said the President, "an overwhelming unequivocal no."

The facts are that the President has his own credit card—the American excess credit card with $692 billion in credit charged to the American people. What is $692 billion? It means that the deficits over the President's 4 years in office will add to the mortgage of every householder in this country, not homeowner, every householder, $9,000. That is the debt this country owes to 4 years of Reaganomics. That is an obligation that they are going to have to pay.

Chairman DOMENICI. Senator, I think we should turn that over that so that those Republican Senators can see it and then those television cameras cannot see it.

Senator METZENBAUM. Please note that that time is not to be charged against me either.

Chairman DOMENICI. See, that fellow out there doing that, he knows who is boss up here. [Laughter.]

BLAME FOR DEFICITS UNFOUNDED

Senator METZENBAUM. The facts are that the President would like to blame this fiscal excess, the deficits on the history of big spending Democratic administration. He says that for decades we have piled deficit upon deficit. Yet, let us look at the facts. There is a chart that we have made indicating where the deficits have come from and how small they were in previous administrations and how overwhelmingly excessive they have become.

The President claims that tax cuts and defense increases do not cause budget deficits. Frankly, that is just plain absurd. President Reagan said deficits we faced are not rooted in defense spending nor is the deficit, as some would have it, rooted in tax cuts. The fact is, said he, our deficits come from the uncontrolled growth of the budget for domestic spending and Treasury Secretary Regan said the structural deficit is not due to the 1981 tax cuts.

The fact is that we cut—we cut ourselves $413 billion as of 1988. We have done our job, and the President overlooks that and glosses over that fact. But the further fact is that supply-side economics, the whole idea of cutting and cutting and cutting with respect to taxes has resulted in the problem that this Nation faces at the moment.

Look at the chart. The solid bars indicate the deficits that we will incur by 1988 with the President's tax cuts. If we had not had the tax cuts, we would be running $140 billion in the black, $140 billion surplus by 1989.

Chairman DOMENICI. If we did not have what, Senator?

Senator METZENBAUM. If we had not had the tax bill.

Now, we would still be able, with those figures, to have the same Department of Defense increases as we have provided for this administration. We would have a surplus in 1988 of $81 billion and a surplus of $19 billion in 1987. And what bothers me is that the President is attempting to confuse the American people as to how we got here and the position that we are in. We are talking about a downpayment. Downpayment, my eye. What we really ought to do is to take away some of the giveaways that we provided in tax loopholes in the tax laws, and what we ought to do is tell the Department of Defense you do not need all you are spending.

BUDGET REFLECTS ADMINISTRATION POLICYMAKERS

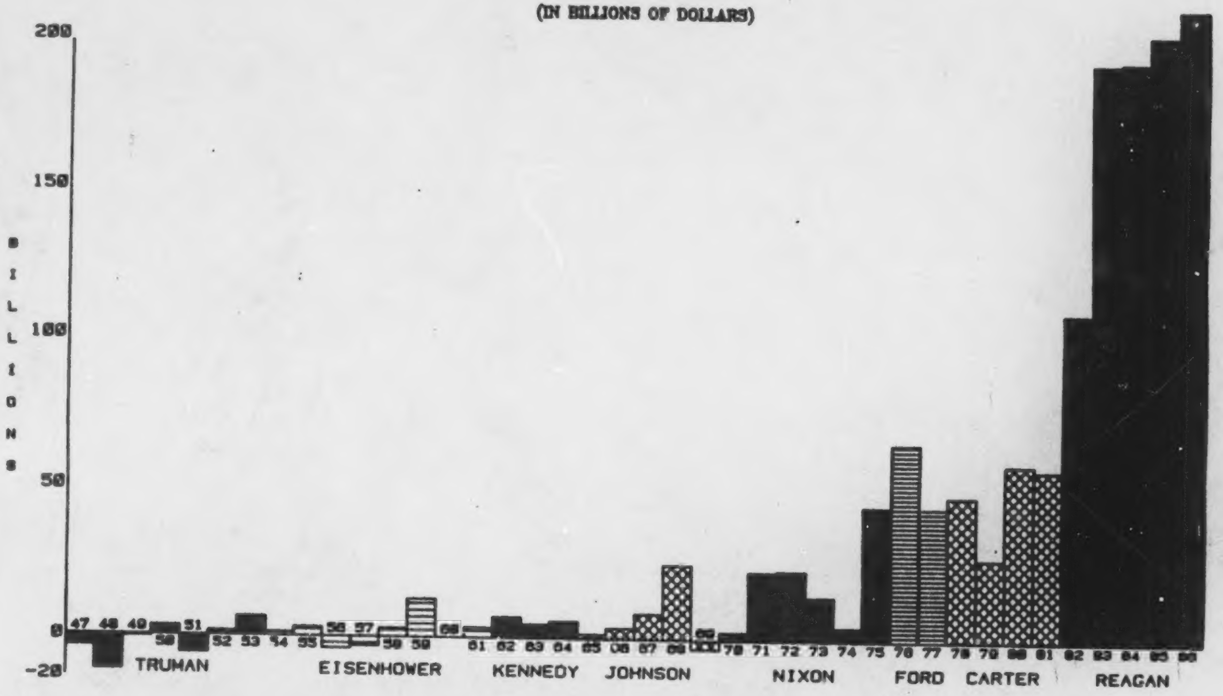
I am afraid that this budget reflects the policymakers of the administration. Those policymakers who are indifferent to the concerns of people in this country, who are willing to continue to be unfair with respect to approaching the challenge that America faces. When a man like Ed Meese says that there are not any hungry children in this country, and when the President of the United States attempts to tell us that the people who are sleeping out on the grates here in Washington and throughout the country are doing so in zero degree weather, and they are doing so because they want to, you can understand the insensitivity of this administration. And I think that we in this Budget Committee have an obligation to zero in on the real problems as they exist and to do something about controlling the deficits which already total $692 billion over the 4-year period of this administration.

I thank you, Mr. Chairman.

HISTORICAL DEFICITS

1947 – 1986

(IN BILLIONS OF DOLLARS)



1984-1986 FIGURES REPRESENT AUGUST 1983 CBO BASELINE ESTIMATES

HOUSE BUDGET COMMITTEE
NOVEMBER 18, 1983

INCREASE IN THE DEFICIT ATTRIBUTABLE TO CONGRESSIONAL POLICY ACTION

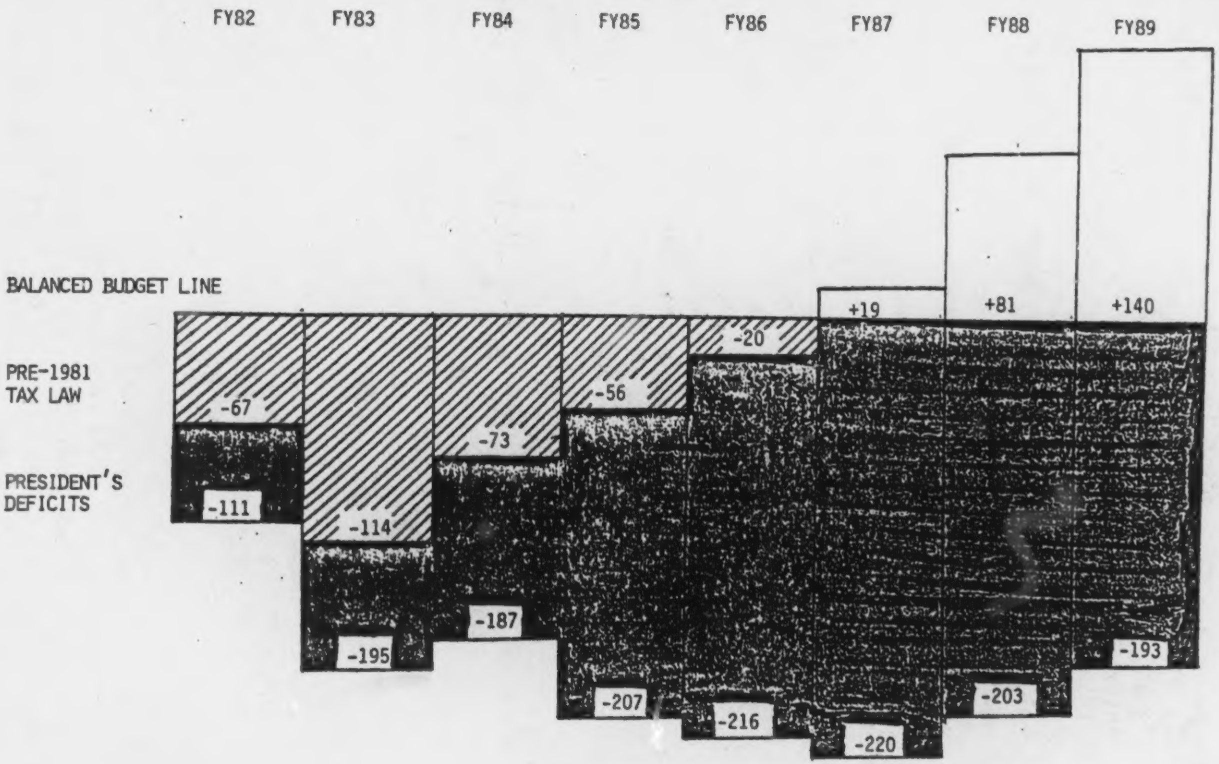
(FISCAL YEARS; BILLIONS OF DOLLARS)

	1982	1983	1984	1985	1986	1987	1988	TOTAL
TAX REDUCTION	44	81	114	151	196	239	284	+1109
DEFENSE SPENDING INCREASES	1	17	25	36	42	54	65	+ 240
NON-DEFENSE SPENDING CUTS	-39	-46	-48	-59	-71	-74	-76	- 413
NET CHANGE IN DEFICIT DUE TO POLICY ACTION	6	52	91	128	167	219	273	+ 936

Chart shows that despite Congressional cuts of $413 Billion in non-defense spending, the deficit will increase $936 Billion over FY 1982-88 period due to Ronald Reagan's tax cuts and increased defense spending.

PREPARED BY THE STAFF OF SEN. HOWARD M. METZENBAUM

SUPPLY-SIDE DEFICITS



Pre-1981 Tax Law= Deficits if President's tax program (cuts and increases) had not been enacted.

President's Deficits= Current Services Deficits contained in President's Fy85 budget.

PREPARED BY THE STAFF OF SEN. HOWARD M. [illegible]

Chairman **Domenici**. The Senator's time is up. He is finished.

I was just going to say, Senator, that I asked Senator Chiles, and he was totally unaware of your promotion day. You kept it a good secret, excellent.

Senator **Metzenbaum**. Am I getting a promotion?

Chairman **Domenici**. No. You were a good promoter.

Senator **Metzenbaum**. What am I going to be?

Chairman **Domenici**. Let us see, Senator Riegle, did you want to make some opening remark?

OPENING STATEMENT OF SENATOR RIEGLE

Senator **Riegle**. Thank you, Mr Chairman.

Mr. Stockman, we have had this now for a couple of days and we have had a chance to take a look at the budget and the analysis that has now been done, I think, indicates clearly that it is a bad budget for the country. It is not a budget that meets our needs and yet it is a budget I think with unacceptable financial consequences, with massive deficits, and I think clearly wasteful defense increases. If we are going to try to increase a defense budget close to 13 percent in real terms for the coming year, and propose to spend over the next 5 years about $2 trillion in addition to what we have already spent in the defense buildup, I think that will clearly break the bank, and I think it is way beyond any rational measurement of our security needs.

At the same time, I do not find any real strategies in here for dealing with a lot of the economic problems that are facing the middle class, not just in our region of the country, but throughout the country. I think most of the middle class is still sliding backward in real terms, if you take a look at the total tax burdens, State taxes, Federal taxes and social security taxes, and then the offsets in Federal income tax changes.

I do not find anything in here that is aimed at fundamentally rebuilding the economic foundation of the country and I do not mean just direct Government spending, but even changes in tax policy or trade policy or other strategies that would enable us to start to add jobs, valuable jobs, and higher paying jobs in this country. As has been said by Senator Metzenbaum, when President Reagan was first elected, he promised he would balance the budget by this year, by 1984, and yet what you are asking for in this budget is an additional deficit of $180 billion if we were to pass this today. If the committee were to just take a vote and pass out exactly what you are here asking for, the President is asking for, we would be accepting an additional $180 billion deficit in the very year that we were promised that we would have a balanced budget and no deficit at all. I just think that is unacceptable, but I do not understand fully, and I will pose it a different way for you in a minute as to how you can make that request, and when I say you, I mean the administration, how the President can come before us in light of those earlier pledges and make that kind of request today. And I want to say something about the work that you have done because I do not think there is anybody in the administration in terms of just physical effort and hours on the job has worked any harder than you have since taking over this job, and I admire the hours and the hard work that have gone into it.

NATIONAL DEBT WILL DOUBLE

By the same token, as the Budget Director, you know, as well as anybody, that you are in the process of doubling the national debt since this administration started. By the time you finish, the national debt will be at least twice as high as it was when the Reagan administration came to town. I mean that is a staggering fact. I know that was not your intention, and I do not think you are comfortable with it today. So I am not saying or suggesting that you are. But that is the fact of the matter, and the problem is that at some point you will leave and the American people are going to be left with the task of trying to pay off this debt. Frankly, I do not see how we are going to be able to do it. I think we are piling it up now at such an extraordinary rate that I do not think we are going to have an ability to actually pay our bills any time soon, and I think it runs enormous risk both for the national economy and the world economy, moreover, the President, who is a master showman, whatever else he may be, and he is certainly that, is able to somehow minimize this massive accumulation of Federal debt which is totally mortgaging the future.

It is by any measure, I think the most irresponsible spending binge we have had in our national history. Now I think today you owe the American people an explanation as to what went wrong, as to why this is what we are seeing rather than the promises and the commitments that were made at the outset. I think the people deserve an explanation as to why we are so far off course and why we have got now this massive buildup in deficits that we seem to be now unable to do really anything about, and which you are in today asking to increase just this year by $180 billion.

I think the reason that we have to determine what went wrong is so that we can try this year, not next year, this year, to work out some kind of a bipartisan answer to this problem.

MAJOR SPENDING CUTS PLANNED

I would just conclude by saying that I read your statement today, and I will get into this in the question period, at the end of your statement, you talk about a whole series of targets for major spending cuts next year. 1985, obviously the year after the election, and I want to get into those because I think if that is the plan, assuming this administration were to be reelected, then I think the people of this country have the right to know honestly today what the plan is that is in a sense being postponed in terms of a tax on certain kinds of problems in that future period.

I must say I did not see anything in there of a consequence about scaling back these defense increases. But you owe us an explanation as to what went wrong, why we are so far off course, and I hope you will give us that today.

Thank you, Mr. Chairman.

Chairman DOMENICI. I understand Senator Biden has a minute and a half or so, and then we are going to proceed to questions unless there is someone on this side who absolutely feels that they must give a speech.

Senator **Andrews**. We get the hint.

OPENING STATEMENT OF SENATOR BIDEN

Senator **Biden**. Mr. Stockman, you are in a tough spot and you have a tough job, and I do not believe Senator Riegle was being solicitous when he suggested that there is some admiration for you up here on this side of the bench. I mean that sincerely.

And we can and we will, I personally will not at this time, but we can argue about how we got to where we are and whether or not what you all have proposed is all bad or all good, but I do not think that is a very fruitful route for us to go. We have had our disagreements, and as you and I were walking in, you said, well, I guess we will go at it again. I have no intention of going at it. I mean this sincerely. Because I think we are really in trouble and I think the future is slipping from our grasp. The fact of the matter is you have done some very good things. For any Democrat to suggest that the fact that inflation is down is not a benefit to the economy I think is being hypocritical. For any Democrat to suggest that there is not a better attitude at this moment on the part of the American public and the confidence in where they are going would be hypocritical.

DECLARE A TRUCE

Conversely, for any of my colleagues on the other side of the aisle to suggest that we are not mortgaging our future literally would also be hypocritical, and we are in a tough spot. We are in an election year, and what I would like to do is, if we can do it, and I mean this sincerely, as one Senator, and I think there are others who share the view on both sides of the aisle, and I think your instinct would be along these lines, although I have not spoken to you about it, I would like to declare a truce. And I do not know whether or not it is possible, I honestly do not know whether it is possible, but I have the feeling from the way in which the social security dilemma was handled, from the way in which we handle other items up here when they get to a crisis point, that when you put people in a room that they tend to come down and make tough decisions which they swore they would never make for political reasons before they went in the room. And the President's invitation to trim the budget, make a downpayment I think is too little, and I must tell you I was suspecious as to whether he meant it, whether it is political or not. But I have observed up here in 11 years that things that start off as political moves sometimes end up producing substantive results beyond what the proposer thought would be the case. And unless we are able to do something about dealing with the deficit, which your team is politically right about, you are politically right as long as the economy is buoyant, people are not going to worry about the deficit. Our team is politically right when we say that deficits are going to cause astronomical problems for us in 1985, 1986, 1987, and 1988.

THE FUTURE IS SLIPPING

The problem is that if we do not act now, we are going to be unable, I truly believe, unable to bring this thing back under control in the late eighties. And so I really think that we can all say all the things that we want to say, but when it is all said and done and we make our political judgments and moves, I hope we are going to repair to backrooms and make some deals, and those deals being in line with truces. And so I want to give the President, and I am not being facetious, I want to give the President as much political leeway as he can, because, as an incumbent, very bluntly it helps me. The fact that the economy is going well does not hurt Democrat Joe Biden. It helps Democrat Joe Biden up for reelection.

Chairman DOMENICI. We suspected that.

Senator BIDEN. No, I really mean this. I know it sounds so naive you would think I had been here only 6 months rather than 11 years. But I really think the future is literally slipping from our grasp, and if we do not do something now, it is over, it is over in the near term. The President can come back with major tax increases, which he will have to do in 1985 if reelected, but it may be too late.

I just want to tell you I have got some specific questions, I am going to try to stay away from hyperbole, and my tendency to point out I told you so, and I hope you will try to stay away from your tendency to do that with me and maybe we can move toward something substantive here.

Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you very much, Senator Biden.

Frankly, I did not know what you were going to say or I would not even have tried to limit how much time you would take. I do appreciate it, and if I said anything to indicate to you that I was doing other than treating it as a very sincere and what I perceived to be a true statement about where we are, I apologize.

Senator BIDEN. No, I did not think that.

Chairman DOMENICI. I think you are absolutely right. We better get something done and argue afterward.

Mr. Stockman, you may proceed.

STATEMENT OF HON. DAVID A. STOCKMAN, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. STOCKMAN. Thank you very much, Mr. Chairman, and members of the committee.

Let me begin by saying, Mr. Chairman, I appreciate very much your kind remarks regarding the fact that I have been running now for 4 years, but I must note that between all the running that you have observed and all the switching and reversing that Senator Chiles has observed, that I am getting a little winded. And I would like to suggest that I think Senator Biden is right, that we accomplish things when we sit down quietly outside the glare of the TV cameras and the bright colors of our charts and graphs and try to grapple with this in a serious and meaningful way.

I am afraid that this problem has become so difficult, so large, so politically charged, that when we meet on occasions like this, we cannot avoid the temptation to engage in excess rhetoric and declamations, and speaking on that, I do have to respond to my good friend the Senator from Ohio, by noting that with each passing year that I come up here, I grow in my appreciation of his sincerity in almost everything he does. But I do want to respond by saying that I followed your analysis on the charts very carefully, and what I think you were saying is that this whole gigantic problem that every member of this committee is aware of, that has been mentioned this morning, this entire problem resulted from the 1981 tax cut. I did not know whether your analysis is right or wrong, but if by chance you are right, I would just say that from your point of view, I regret that when I came, up here in 1981 I was so brilliant and persuasive that I talked you into voting for it.

Senator METZENBAUM. I did indeed.

Mr. STOCKMAN. But I think most of us believed as we looked at this a little harder and a little more closely that there is no single element that can be blamed for the national predicament that we have today with which none of us are comfortable and which none of us believe can be allowed to persist.

DEFENSE SPENDING HAS MAJOR RECOVERY

I think the chairman made some very good observations in his opening statement to point out that even though these defense increases have been large, they have been, in the main, supported, ratified, endorsed by the Congress and by both parties. We have had a major recovery in defense spending since 1980. It was needed because every component and facet of our national defense and military establishment was in bad shape in 1980. But along the way to recovery and restoration, after the usual and serious and intensive and noisy debate about the real growth rate and the size of the number in this committee and the counterpart committee in the House, 95 percent of what we requested from the Congress has been approved when all is said and done, when we moved away from that big number and that real growth rate and started to look at the specific items and components and allocation of what these funds were required for.

I think he was also right when he said that even with the large tax cut that Senator Metzenbaum pointed to in his initial remarks, that taxes relative to the goods and services produced by the American people, relative to the income that people received as their reward for a productive contribution to our society, are no lower today than they have been in the entire postwar period. In fact, I think there are only 3 or 4 years in which the tax share of GNP was above the 19½ percent which would occur under the budget that we are recommending.

Now, we can argue about who was right and wrong when decisions were made to launch major spending programs in the sixties and seventies, that grew into enterprises far beyond what was predicted or projected at the time. We do not have to itemize the programs here this morning in which that occurred. We have talked about it many times. But it seems to me that we cannot reverse the course of history and, therefore, we have to deal with the facts of life as they present themselves today. So I would like to propose——

Chairman **Domenici**. Mr. Stockman, excuse me. Would you permit me to interrupt for 30 seconds?

DEFICIT IS ATTRIBUTABLE IN PART TO ECONOMIC ASSUMPTION ERRORS

In my opening remarks, I failed to make one other observation. I will make it now, and I ask you not to comment on it yet. I asked the staff throughout last year's process what the 1984 budget resolution envisioned for spending for the years 1984 through 1986. I found that congressional spending totaled $2.7 trillion. I then compared it with the original request for spending of the President during the same period, and I found that the President's request was higher, $2.749 trillion.

I think for purposes of our discussion here, you can say the requests are identical. Now, that tells me something. It suggests that the deficit is attributable to something in addition to that expense side, and I submit a significant portion is economic assumption errors due to a recession. But I would like in due course for you to address that. You can assume the numbers are right and you can check them later.

Mr. **Stockman**. Well, thank you, Mr. Chairman. I will comment on that in questions as they come along.

I just want to finish by saying that it has been suggested that the entire burden of controlling and containing and attempting to reduce this deficit has fallen on domestic spending and that is somehow wrong and that there needs to be a major recovery in that area.

DOMESTIC PROGRAM DOLLARS ALMOST DOUBLE

Well, if you look at things item by item, year by year, you can make almost any case that you want as to whether things are going up or down or sideways. I think that we have to have a somewhat longer view, a somewhat broader view, and a somewhat more cogent view, and the fact is that in 1970 we may not have been meeting all the domestic needs of this country, we may have had social problems that needed to be addressed and that required Federal expenditures that did not exist at that time. But we were not in the dark ages, we were not in the 19th century, we had a well developed network of social support programs in this country in 1970 that were meeting many of our needs. In constant dollars, those programs cost $270 billion in 1971. And after all the cutting and after all the arguments that we have had over these last 3 years, we are proposing for the very same set of domestic programs $523 billion, or nearly double in this 1985 budget.

Now, we can argue until the cows come home as to whether the dollars are being allocated in an appropriate way, whether there are cracks in the net, for instance, in nutrition or, in the issue of hunger that was raised, but in the aggregate, across-the-broad stretch of all the things that we do to provide income for the low income and needy, to provide social insurance to the unemployed and the retired and the ill, to provide a whole array of different kinds of subsidies and assistance to State and local governments to carry on useful purposes in our society, I do not think it can be said that somehow in 1984 or 1985 we have turned back the clock when we are spending twice as much as we were as recently as 1970.

So these are the basic facts that lead to the dilemma that we are in today. I had planned to respond to the fact that the committee has winded me rather severely for the last 3 years by winding you with a 30-page testimony. I will put that in the record and hope that we can proceed for the remainder of the time here to respond to constructive questions that I know all members of this committee have.

I think if we get into cosmic arguments about how we got here, to this dilemma posed by a $180 billion deficit in 1985, to the threat that it portends to the future if it is not corrected, we are going to end up with nothing. But if we are willing to work within some realistic and practical constraints as to where we can agree in this election charged environment and where we most probably and certainly cannot, and they focus on the former and put some confidence in the leaders appointed by the Senate and the House, I believe that this process of bipartisan negotiation that was initiated by the President can lead to something useful and concrete. It will not solve this problem by any means, but it will help contain it, it will implement measures that will do some actual good in reducing the flow of red ink and leave us in a position so that when we come back here next year, we can work on the problem in the context of an economy that is still moving forward.

So I will close my opening remarks with those comments and the invitation that all of us work in a serious way in the next couple of months to see what we can get done.

Thank you, Mr. Chairman.

Chairman Domenici. Thank you, Mr. Stockman.

[The prepared statement of Mr. Stockman follows:]

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

TESTIMONY OF THE

HONORABLE DAVID A. STOCKMAN

DIRECTOR,

OFFICE OF MANAGEMENT AND BUDGET

BEFORE THE

COMMITTEE ON THE BUDGET

UNITED STATES SENATE

FEBRUARY 2, 1984

I. THE 1985 BUDGET PLAN

The President's 1985 Budget represents a modest further step on the long and difficult road to fiscal balance that lies ahead. It builds upon and extends the far-reaching progress made thus far in re-ordering national priorities and restraining the growth and size of domestic government. Major features of the 1985 Budget include:

- continuing through the end of the decade the virtual freeze on constant dollar domestic spending that has been in place since 1981;
- continuing the necessary realignment of budget priorities toward defense, national interest programs and other core purposes of government;
- preserving the economically essential individual tax rate reductions, business depreciation reforms and indexing provisions enacted in 1981, while pointing the way toward future tax code reform and base broadening;
- stabilizing the projected budget deficit over the next several years at about $180 billion, resulting in a decline in the deficit share of GNP from 6.0% in 1983 to 3.9% by 1987;
- reserving for next year the large structural reforms in major budget components that will be needed to bring spending and revenues back into alignment -- thereby preserving non-inflationary real economic growth over the longer term.

A. BUDGET TOTALS

The various components of the proposed 1985 Budget result in a stabilization of the deficit at about $180 billion over the next several years. Receipts are projected to grow by about 10% per year and outlays by about 8% per year -- with defense outlays growing faster than average and debt service and non-defense spending more slowly. These policies do not appreciably reduce the absolute level of the deficit from its 1983 peak. But relative to GNP the deficit falls by about one-third.

FY 1985 Proposed Budget
(billions of dollars)

	1984 Est.	1985	1986	1987
o Outlays	853.8	925.5	992.1	1,068.3
o Receipts	670.1	745.1	814.9	887.8
o Deficit	-183.7	-180.4	-177.1	-180.5

Average Annual Increase, 1984-87:

o Receipts	9.8%
o Outlays	7.8%
o Defense	13.6%
o Debt Service ...	6.5%
o Non-Defense Programs	5.0%

Deficit Share of GNP:

o 1983 Actual	-6.0%
o 1984 Estimate	-5.2%
o 1985 Budget	-4.6%
o 1986 Budget	-4.2%
o 1987 Budget	-3.9%

B. NON-DEFENSE APPROPRIATIONS

The 1985 discretionary spending authority request for the eleven non-DOD Appropriations bills is $170 billion. This consists of $132.7 billion in new budget authority plus $37.5 billion in obligation, administrative expense and lending limitations*.

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* Excludes appropriated entitlements, mandatory spending and various pro forma budget authority amounts.

For non-DOD appropriated programs as a whole, the 1985 request represents:

- a 2% increase over 1984 enacted levels;
- a $0.6 billion or less than a 1% increase relative to the 1985 current services baseline.

Among the eleven non-DOD appropriations bills, the 1985 request proposes net increases to the current services level for 4 bills, net decreases for 5 bills and no change for 2 bills.

1985 REQUEST, NON-DOD ANNUALLY FUNDED SPENDING AUTHORITY 1/
(dollars in millions)

	1985	Compared to 1985 Current Services		Compared to 1984 Enacted	
Appropriations Bill	Request	Amount	Percent	Amount	Percent
1) Foreign Operations	17.9	+4.6	+35%	+5.1	+40%
2) Energy & Water	15.8	+0.7	+5%	+1.5	+11%
3) HUD/Independent	29.5	+0.6	+2%	+1.6	+6%
4) Transportation	27.1	+0.2	+1%	+1.3	+5%
5) Commerce/State/ Justice	11.3	---	---	+0.9	+9%
6) District of Columbia	0.5	-0.1	-15%	-0.1	-17%
7) Interior	8.1	-0.7	-8%	---	---
8) Agriculture	13.9	-1.8	-12%	-5.0	-26%
9) Treasury/Postal	8.9	-0.2	-2%	+0.2	+3%
10) Labor-HHS	36.5	-2.7	-7%	-2.0	-5%
11) Legislative Branch	0.7	---	---	-0.1	-12%
Total	170.2	+0.6	.4%	+3.5	+2%

1/ Includes obligational and loan limitations as well as new budget authority. Excludes subsidized housing and related accounts and one-time 1984 special appropriations for IMF and Amtrak.

The proposed increases and decreases in 1985 spending authority -- along with continuation of roughly similar policy levels in the out-years -- result in a slight increase to the current services outlay baseline for non-DOD discretionary appropriations.

OUTLAY EFFECT OF NON-DOD DISCRETIONARY APPROPRIATIONS REQUEST

(dollars in billions)

	1985	1986	1987	Total
Current Services	153.2	156.2	160.2	469.6
FY 1985 Budget	+1.4	+1.8	+2.8	+6.0

C. ENTITLEMENTS AND OTHER MANDATORY SPENDING

Under current law, entitlements and other mandatory spending would total $396 billion in FY 1985, an 8% increase over the 1984 enacted level. Moreover, these outlays comprise 72% of the $550 billion non-DOD, non-interest outlay baseline for 1985

Further steps toward restraint and reform are therefore imperative. The President's budget proposes limited measures at the present time -- with the clear understanding that even larger measures to reduce the automatic growth of these entitlement spending programs will be needed in the future. For 1985-87, the President's budget proposes:

- o Medicare savings of $6.5 billion due to a phased increase in the Part B premium, a temporary freeze on physician fee increases and other smaller changes;
- o Federal retirement program savings of $6.4 billion due to COLA delays, and modest civilian retirement system changes;
- o Medicaid savings of $3.3 billion by extending the 1981 Reconciliation Act 3% matching reduction and mandatory co-payments for all services and beneficiaries;
- o Subsidized housing savings of $1.2 billion (attributable to a number of small cost-saving steps)

- Nutrition program and AFDC savings of $4.3 billion principally due to error rate reduction and tighter eligibility definitions;
- Farm price support savings of $3.2 billion due to a freeze on target prices and the dairy price support level after the current paid diversion expires;
- GSL, pension benefit guarantee premium and other modest changes resulting in $3.9 billion in savings over three years.

While many of these reform measures will be strongly challenged by special interest groups, it should be noted that they result in only a 2% reduction in the current services baseline over the next three years.

PROPOSED SAVINGS IN MANDATORY AND ENTITLEMENT SPENDING PROGRAMS
(dollars in billions)

	1985	1986	1987	Total
o Current Services Baseline	396.4	419.4	450.1	1,265.9
o Proposed Savings:				
o Medicare	-1.0	-2.1	-3.4	-6.5
o Medicaid	-1.1	-1.1	-1.2	-3.3
o AFDC	-0.8	-1.0	-1.1	-2.9
o Food Stamps/Child Nutrition	-0.4	-0.5	-0.5	-1.4
o Civilian & Military Retirement	-0.8	-2.4	-3.1	-6.4
o Farm Price Supports ..	+0.1	-1.8	-1.5	-3.2
o GSL	-0.2	-0.2	-0.2	-0.5
o Pension Benefit Guarantee Premiums .	-0.2	-0.2	-0.2	-0.5
o Subsidized Housing ...	-0.2	-0.4	-0.5	-1.2
o Other	-0.8	-0.4	-1.6	-2.9
o Total	-5.5	-10.0	-13.4	-28.9
o Savings as % of Baseline	1.4%	2.4%	3.0%	2.3%
o Memorandum Item: Current Services Baseline for Social Security and Other Programs not Proposed for Change	234.0	247.8	262.7	744.5

D. DEFENSE REQUEST

The President's 1985 budget request represents a continuation of the necessary defense build-up begun on a bipartisan basis in FY 1981. Progress thus far is substantial:

- the 1984 enacted appropriations bills represent an increase of $116 billion or 82% from the inadequate 1980 level;
- real defense purchasing power has risen 41% -- reversing the deep decline that occured in the 1970s;
- major progress in boosting pay, improving retention, recruitment and training, restoring readiness levels, correcting the strategic imbalance and modernizing conventional weapons system has been made.

The 1985 request represents the level of funding needed to continue the programs and objectives ratified and supported by the Congress since FY 1981. While the proposed $47 billion budget authority increase, representing 13% real growth over the 1984 enacted level, may appear to be large in aggregate terms, the programmatic details behind it largely represents follow-on funding for efforts broadly supported by Congress in the last four budget rounds. Specifically, major components of the requested increase include:

- a $3.1 billion increase for military and civilian personnel. In 1984, Congress insisted on a 4% pay increase in lieu of the Administration proposed freeze;
- a $1.9 billion increase for the 1985 installment of major strategic systems, included B-1, the MX-small missile compromise plan, Trident II, air-launched cruise missiles and the advanced bomber. All of these systems have received strong Congressional endorsement over the past several years;

- a $13.8 billion increase for major conventional system modernizations including F-14s, -15s, -16s and -18s, the M-1 tank, Bradley fighting vehicle and AH-64 attack helicopter, Aegis ships and support ships to compliment the approved 15 carrier-battle groups, and various air- and sea-lift capabilities and tactical aircraft. Aside from some differences over the annual quantity mix, all of these systems in their current form have been repeatedly supported in congressional funding bills;
- a $1.1 billion increase for military retirement including system cost accruals as per the 1984 Congressional amendments;
- a $5.9 billion increase for basic readiness items including flying and steaming hours, training exercises and maintenance;
- a $7.6 billion increase for war stocks and peacetime operational reserves of spares and munitions;
- a $6.7 billion increase for cost of R&D, Military construction and other initiatives delayed or deferred by Congress in FY 84;
- a $6.7 billion increase for all other items ranging from routine base operations to advanced R&D.

With the possible exception of the last items, these increases represent the 1985 cost of existing Congressional policy. While strong arguments about the precise magnitude of some of these increases can be made by both proponents and opponents, these are differences mainly about timing and the pace of increase -- rather than the fundamental thrust of the defense build-up.

Indeed, the actual pattern of program deferrals, stretch-outs and minor trimmings contained in appropriations bills enacted by Congress over the last three years demonstrate this. As is shown in the table below, enacted appropriations over 1982-84 have totaled 94.2% of the Administration's request. Moreover, nearly

40% of the reduction has been attributable to pay raise and retirement pay differences, inflation assumptions and other purely financing issues. Actual program reductions have averaged only $10.4 billion during the last two years.

OUTCOME OF DOD APPROPRIATIONS PROCESS, 1982-84
(Budget Authority, in billions of dollars)

	1982	1983	1984	Total
o Administrations's Request	221.8	257.5	273.4	752.7
o Pay, Inflation, Financing Changes ..	-2.9	-8.0	-5.4	-16.3
o Net Program Deferrals or Reduction	-6.6	-10.9	-9.9	-27.4
o Total Reduction	-9.5	-18.9	-15.3	-43.7
o Total Enacted as % of Request	95.7%	92.7%	94.4%	94.2%
o Program Reduction as % of Request	3.0%	4.2%	3.6%	3.6%

Thus, the 1985 DOD request will undoubtedly give rise to a contentious numbers debate for the next several weeks. But, as the details of the defense program are examined, it should become increasingly clear that the "increase" simply reflects the 1985 cost of the nation's unavoidable and necessary effort to restore its military capabilities and national security -- an enterprise that was launched on a bipartisan basis in 1981 and which has enjoyed broad Congressional support in all of its significant particulars ever since.

1985 DOD REQUEST
(dollars in billions)

	1984 Enacted	1985	1986	1987
Budget Authority (B.A.)	258[1]	305	349	379
Budget Outlays	231	264	302	339
% B.A. Real Growth[2]	--	+13.0%	+9.2%	+3.5%
Outlay Savings from 1984 Request	--	-13	-13	-6

[1] Assumes supplemental for 4% pay increase
[2] Budget authority with DOD weighted deflator

E. REVENUE CHANGES

The modest revenue changes proposed in the FY 1985 Budget embody four essential principles: 1) preservation of the across-the-board rate reductions, business depreciation reforms and indexing provisions of the 1981 tax act as essential for continued economic recovery; 2) strengthening and broadening of the tax base through elimination of unwarranted loopholes and obsolete provisions; 3) support for important economic and social policy objectives through tax incentives rather than direct spending; and 4) preservation to the largest extent possible of the net tax reduction enacted since 1981.

As is shown in the table below, proposed revenue increasing measures total $41.4 billion over 1985 - 1987. Three-fourths of this increase is accounted for by the proposed health insurance cap, tax-exempt leasing restrictions and increased federal employee pension contributions. The remainder consists of revised provisions regarding IDBs, tax shelters, accounting methods, life insurance taxation and corporate tax abuses.

The 1985 - 1987 revenue loss attributable to proposed tax incentives totals $7.9 billion, with $2.1 billion attributable to broadened IRA eligibility and other women's initiatives, and $2.2 billion to tuition tax credits and the higher education savings account proposal. Overall, the net receipt change is $7.8 billion in FY 1985 and $33.5 billion over the 3-year period.

REVENUE PROPOSALS IN 1985 BUDGET
(dollars in billions)

	1985	1986	1987	Total
Current Services	737.3	803.4	873.7	2,414.4
Revenue Increases:				
o Health Insurance Cap	3.9	6.5	8.0	18.3
o Employee Pension Contributions	0.7	1.4	1.5	3.6
o State & Local Leasing	1.7	2.7	4.0	8.4
o Other Loopholes/Reforms ..	2.6	3.9	4.6	11.1
o Subtotal	8.9	14.4	18.0	41.4
Tax Incentives:				
o Broadened IRA & Other	-0.3	-0.9	-0.9	-2.1
o Tuition Tax Credit & Higher Education Deduction	-0.4	-0.7	-1.1	-2.2
o Enterprise Zones	-0.1	-0.4	-0.8	-1.3
o Extension of Jobs Credit, R&D Incentives and Other	-0.3	-0.8	-1.1	-2.2
o Subtotal, Tax Incentives .	-1.0	-2.9	-3.9	-7.9
Total Change				
o Net Revenue Increase	7.8	11.6	14.1	33.5
o % of Baseline	1.1%	1.4%	1.6%	1.4%

The modest revenue increases proposed in the FY 1985 Budget are consistent with the President's objective of preserving to the maximum extent feasible the net tax cut enacted since 1981. As shown below, the net tax reduction for 1985 will be $106 billion rising to $159 billion by 1987. For the 1982 - 1989 period as a whole, the net tax reduction due to policy changes since 1981 will total $972 billion.

NET TAX REDUCTION SINCE 1981
(dollars in billions)

	1985	1986	1987	Total 1982-89
1) Economic Recovery Tax Act (1981)	-165.0	-207.7	-248.5	-1,488.1
2) TEFRA -- 1982	+39.7	+49.3	+60.7	+327.0
3) Surface Transportation Tax Act -- 1982	+4.2	+4.4	+4.5	+28.0
4) Bipartisan Social Security & Railroad Solvency Bills	+9.5	+10.4	+12.5	+95.6
5) Other	-2.4	-2.1	-1.7	-12.6
6) FY 1985 Budget Proposals	7.8	11.6	14.1	78.5
7) Net Tax Reduction ..	-106.0	-134.2	-158.5	-971.6
Memo Item: Net Tax Reduction as Share of GNP	2.7%	3.2%	3.5%	3.0%
Memo Item: Impact of 1977 Social Security Tax Increase 1/	+38.5	+44.2	+47.4	+310.5

1/ Changes from law in effect at end of 1976.

II. DOMESTIC SPENDING RESTRAINT: ACHIEVED AND PROPOSED

The remaining budget deficit is large and defines an imposing task for future structural reform. However, it should not be concluded that the unprecedented and determined bipartisan measures to restrain runaway spending growth enacted since 1981 have not had a major impact. In fact, four major trends dramatize the magnitude of progress thus far and the further opportunities for restraint over the remainder of the 1980s;

1) Domestic spending will be $70 billion lower in 1985 and $318 billion lower over 1982-86 than would have been the case under pre-1981 law and policy:

DOMESTIC PROGRAM SAVINGS ENACTED THUS FAR, 1982 - 1986

Year	Pre-1981 Baseline*	Savings Enacted	Percent Reduction	Savings as % of GNP
	(billions)		(percent)	
1982	489	-36	7.4	1.2
1983	547	-60	11.0	1.9
1984	565	-66	11.7	1.9
1985	602	-70	11.6	1.8
1986	641	-86	13.4	2.0
Total	2,844	-318	11.2	1.7

* All pre-1981 baseline entitlements and mandatory spending represents prior law as of January 1981, adjusted for actual and forecast economic assumptions over 1982-86. Discretionary spending equals the recommended amounts for 1982-1986 in the outgoing Carter Administration FY 1982 Budget. 1985 and 1986 savings are based on FY 1985 current services estimates. Figures include off-budget outlays. "Domestic programs" do not include DOD-military, net interest or $27 to $37 billion per year in national interest program expenditures for space, international affairs, DOE weapons program and related items as detailed beginning on page 3-49 of the FY 1985 Budget.

2) Constant dollar domestic spending will be $4 billion lower in the Congressionally enacted 1984 budget than in 1981. Under the President's proposed FY 1985 Budget, constant dollar domestic spending will remain frozen in the $520 to $530 range through the remainder of the decade. Even under current services (no further savings) it will rise only 7% between 1984 and 1989. This prospect of a decade-long freeze in real terms contrasts dramatically with the 27 years between 1954 and 1981, when real domestic spending increased nine-fold:

TREND IN CONSTANT DOLLAR DOMESTIC SPENDING
(billions of constant 1985 dollars)

Pre-1982	Amount
1954	58
1961	126
1971	270
1981	527
Since 1982	
1984 Enacted	523
1985 Proposed	523
1989 Proposed	529
1989 Current Services .	558
Average Annual Real Growth	
1954-1981	8.5%
1981-1984 Enacted	-0.2%
1981-1989 Proposed	0.1%
1981-1989 Current Services	0.7%

3) The economic burden of the domestic budget has begun an historically unprecedented decline. After rising from 4% to 15% of GNP between 1954 and 1981, domestic spending in the 1984 budget will decline to 14% of GNP. With the additional restraint proposed in the 1985 budget, it will decline to 11.6% by 1989. Even under current services baseline projections, domestic spending will fall to 12.3% of GNP by the end of the decade -- nearly a one-fifth reduction in the economic burden of the domestic budget relative to 1981 peak levels:

DOMESTIC SPENDING AS A PERCENT OF GNP

Pre-1982	% of GNP
1954	4.0%
1961	7.3%
1971	10.5%
1981	15.0%
Since 1982	
1984 enacted	14.0%
1985 budget	13.4%
1989 budget	11.6%
1989 current services .	12.3%

4) Policies are now in place which will restrain all major components of the domestic budget compared to the unsustainable trends of prior decades:

- current services social insurance costs will grow at 2.3% per year in real terms between 1983 and 1989 compared to 8.8% between 1954 and 1983;
- current services low-income benefit programs will stabilize at $65-72 billion per year in constant dollars from 1981 through 1989 -- compared to constant dollar growth from $21 billion to $68 billion between 1970 and 1981;
- other domestic spending will have declined from its constant dollar peak of $208 billion in 1978 to $158 billion in the enacted 1984 budget -- a drop of 24%. Further contraction will occur under current services through the remainder of the decade.

Thus, the first step toward long-run fiscal stability has been achieved: domestic spending has been reduced substantially compared to prior policy; unsustainable real growth has been brought to an abrupt halt; and the domestic spending claim on GNP is finally heading down. The next steps must be focused on structural reform: the actual elimination, consolidation or reduction of existing spending commitments with a view to closing the budget gap at an affordable, justifiable and sustainable share of the goods and services produced by the American people each year.

III. EIGHT POSSIBLE AREAS FOR FUTURE STRUCTURAL REFORM AND MAJOR BUDGET SAVINGS

While major strides in budget control have been achieved over the past three years, it should not be concluded that all savings possibilities have been exhausted. Some programs such as agricultural price supports and student aid have escaped the general regime of fiscal restraint since 1981 and must now be firmly curtailed. Consideration of other major reform candidates -- such as military and civilian retirement -- has been deferred, but these programs must be subjected to fundamental scrutiny and revision next year. Finally, the Grace Commission report contains literally hundreds of suggestions in the areas of federal overhead reduction, procurement reform, and unjustified economic subsidies which, after further analysis and refinement, can be expected to generate substantial savings proposals for next year's budget.

In particular, the following eight budget categories illustrate the opportunities for significant future savings beyond the limited measures proposed in the 1985 budget. In most cases, the detailed analysis necessary to estimate savings and justify proposed policy changes is still underway -- with much work yet to be done. Nevertheless, they illustrate both the major opportunities as well as the kind of hard choices which will face the Administration and Congress next year in what must be a full-throttle effort to close the budget gap, if economic recovery is to be sustained.

1) Farm Price Supports

As is shown below, the 1981 farm bill will result in the highest constant dollar net outlays of any 5-year period in recent history. Fortunately, this counter-productive law expires beginning with the 1986 crop year. This presents an opportunity for major savings beginning in FY 1987 if a more market-oriented price support and subsidy program can be fashioned next year. The current wide gap between out-of-pocket production costs and price support and target levels must be substantially closed if costly surpluses and major commodity market imbalances are to be avoided in the second half of the decade:

POTENTIAL FOR FARM PRICE SUPPORT AND SUBSIDY SAVINGS: CONSTANT DOLLAR COSTS OF 1981 FARM BILL COMPARED TO PRIOR PERIODS
(billions of constant 1985 $)

	Average Annual Constant Dollar Outlays	% of 1981 Farm Bill (1982-86)
1962-1966	9.4	76%
1967-1971	10.0	81%
1972-1976	4.9	40%
1977-1981	6.1	50%
1962-1981 Average ...	7.6	62%
1981 Farm Bill, 1982-86	12.3	100%

2) Student Aid and Higher Education

Between 1970 and 1978, constant dollar federal support for student aid and higher education increased from $3.6 billion to $5.5 billion or about 53%. This substantial rise in real spending levels was generally consistent with the 80% constant dollar increase in overall domestic spending, excluding social insurance and low-income entitlements, which occured during this same period.

Since 1978, however, constant dollar spending for non-entitlement domestic spending has declined markedly as shown in the table below. By contrast, 1984 enacted student aid and higher education constant dollar outlays will be 46% higher than 1978 and only slightly below peak levels reached in 1981 ($8.3 billion). Thus, this category of the budget has escaped the general retrenchment of non-entitlement spending almost entirely. Since federal support of nearly 50% of all students enrolled in instutitions of higher education is more than the Nation can afford, a substantial funding rollback will be an unavoidable imperative on the structural reform agenda for future budgets:

CONSTANT DOLLAR STUDENT AID AND HIGHER EDUCATION FUNDING TRENDS VS OTHER DOMESTIC SPENDING

(billions of constant 1985 $)

Year	Domestic Spending Excluding Social Insurance and Low-Income Benefits*	Student Aid and Higher Education
1970	115.4	3.6
1978	207.7	5.5
% Change from 1970.	+80%	+53%
1984 Enacted	158.4	8.1
% Change from 1978.	-24%	+46%

* As detailed in Part III, FY 1985 Budget.

3) Veterans Health Care System Efficiencies and Improvements

The operating and construction costs of the nation's veterans health care system nearly doubled in real terms between 1970 and 1980. Moreover, unlike most other categories of discretionary spending, constant dollar costs have continued to rise -- with the 1984 enacted budget up a further 8% in real terms from the 1980 level. Under the 1985 budget proposals, projected future costs continue to increase in real terms, rising by 30% between 1980 and 1989.

This rising cost trend represents both increases in medical care costs generally and the increasing pressures brought on the existing, inadequate VA system by a rising number of eligible veterans. Within the framework of current eligibility criteria, delivery system organization and hospital capacity, it is extremely doubtful that this continued rise in real budget costs can be avoided. However, the Grace Commission findings, as well as those by many medical economists, suggest that the nation's health care commitments to its veterans can be met at substantially less cost over the longer run if the current policy framework is adjusted. Such structural reform options include greater internal economic incentives, wider use of excess facilities in the private health care system, tighter implementation of the "inability to defray" standard, firmer service-connected disability requirements, and cost-sharing and third party cost recovery mechanisms. The Administration will be studying these options intensively within the coming years, with a view to finding ways to meet existing veterans health care commitments at significantly lower costs in the years ahead:

CONSTANT DOLLAR TREND IN VA HEALTH CARE SYSTEM

(billions of constant 1985 $)

Year	Constant Dollar Budget
1970	4.7
1980	8.7
Percent Change from 1970	85%
1984 enacted	9.4
1987 proposed	10.6
1989 proposed	11.3
Percent Change from 1980:	
1984	+8%
1987	+21%
1989	+30%

4) Medical Entitlements

The rapid, sustained constant dollar growth of the medicare and medicaid programs are nearly unprecedented in federal budget history. Between 1968 and 1981, the constant dollar cost of these entitlements rose from $17.8 billion to $65.8 billion -- or at a compound annual rate of 10.4%. Despite a variety of cost-saving reforms adopted since 1981, 1984 constant dollar spending will be up another $17 billion reflecting a 7.9% rate of annual increase. By contrast, overall domestic spending has actually declined in real terms during the same period.

Moreover, even assuming the tight reimbursement restraints embodied in the prospective payment system for medicare (DRG) and similar state level medicaid reforms, constant dollar current services costs are projected to rise another $36 billion by 1989 -- representing a 7.5% rate of annual real increase from the 1984 level.

These trends make clear that much more must be done to restrain the cost growth of the federal medical entitlements. Without such additional efforts there is virtually no prospect of maintaining medicare solvency in the 1990s, nor of meeting the rising needs of the low-income elderly and families assisted by medicaid.

Since the underlying source of this enormous, sustained cost growth lies in the structural inadequacies and inefficiencies of the U.S. health care system and the lack of economic incentives for providers and beneficiaries alike, only generic reforms of a fundamental and far-reaching nature offer the potential for significant long-term cost reduction. Such generic reforms in the areas of reimbursement, health care delivery system organization, provider risk absorbtion and beneficiary cost-sharing are therefore essential items for future consideration.

CONSTANT DOLLAR TREND FOR MEDICARE/MEDICAID
(billions of constant 1985 $)

Year	Constant Dollar Budget Level
o 1968	17.8
o 1981	65.8
o Annual real growth from 1968	10.4%
o 1984 enacted	82.7
o Annual real growth from 1981	7.9%
o 1989 current services .	118.8
o Annual real growth from 1984	7.5%

5) Federal Military and Civilian Retirement Pensions

Federal civilian and military retirement pensions have historically been more generous than their private sector counterparts for reasons that have now been largely surpassed by events and policy changes over recent years. It was argued that low military pay levels prior to 1974 justified large pensions and generous early retirement privileges as a form of "deferred compensation." Likewise, until the 1983 Social Security Act, federal civilian pensions served the dual prupose of providing both a basic social insurance equivalent as well as a private pension supplement.

Nevertheless, even on the basis of these often tenuous justifications, military and civilian pension benefits have skyrocketed since the late 1960s. Whether measured in terms of cost of payroll or replacement of prior earnings, they vastly exceed comparable retirement annuity levels available in any sector of private employment. For instance, the normalized cost of current civilian annuities is estimated at 36% of payroll, compared to a 22% cost average for combined social security and private pensions in the better private sector plans.

These excessive pension levels have had an enormous adverse impact on the federal budget. As shown below, constant dollar budget costs rose from $6.5 billion in 1962 to $38.5 billion in 1981 -- an average annual growth rate of 9.8% per year. Constant dollar pension costs have increased another 6% since 1981, and current services real costs are projected to rise an additional 12% by 1989. Stated differently, by 1989 current services federal pension costs alone will exceed 1% of GNP.

These trends make clear that the fiscal burden of federal retirement pensions must be reduced substantially in the future. With both military pay at competitive rates and new federal civilian employee coverage under social security, next year's budget will present a long-overdue opportunity to constrain the cost of existing annuities, and prospectively bring federal pension benefits in better alignment with those available to private employees throughout the U.S. economy.

TRENDS IN CONSTANT DOLLAR FEDERAL MILITARY AND CIVILIAN PENSION COSTS
(billions of constant 1985 $)

Year	Constant Dollar Budget Level
1962	6.5
1981	38.5
Average compound annual growth rate	9.6%
1984	40.8
1989 current services	45.7

6) Federal Civilian Employment

In 1985 the 2.1 million federal civilian payroll will cost $61 billion for basic compensation, health benefits, unemployment insurance and disability benefits. While considerable progress has been made in reducing excessive staffing levels in many agencies, total civilian employment remains near its 1981 level.

The detailed analysis offered by the Grace Commission of both government-wide personnel policies and individual agency staffing patterns strongly supports the presumption that major costs savings in this area are feasible. The more promising options include more aggressive contracting out through A-76 procedures; reduced staff layering and overlap between operating bureaus and departmental levels; reduction of excessive sick leave, vacation and annual leave entitlements which would permit equal work to be done with fewer FTE's; and more appropriate job classification procedures and pay comparability methodologies.

Due to the size of the federal work-force and the high rate of attrition, it would not take draconian staffing reduction to generate significant savings over a reasonable period of time. On a fully implemented basis, a 5% reduction in the federal work force by 1988 would yield savings of $3.7 billion per year.

1985 COST* OF FEDERAL CIVILIAN WORK FORCE

(in billions of dollars)

Basic compensation	56.6
Health benefits	3.4
Unemployment insurance ...	0.2
FECA	0.8
Total	61.0

7) Improved Federal Procurement

Federal procurement costs in 1985 are projected to be $207 billion -- an 88% increase from the 1980 level. While the unique nature of many federal procurements -- particularly in the defense area -- makes cost comparisons with private sector practices difficult, there is little doubt among informed analysts that major cost reductions are possible with changes in existing policies and methods. Over the past three years, the Administration has launched sweeping efforts to simplify and consolidate federal procurement regulations -- and these efforts are beginning to produce tangible results.

Nevertheless, large savings depend upon basic policy changes -- most of which must be approved or supported by the relevant congressional committees. These include more extensive use of multi-year contracting, increasing the share of procurements subject to competitive bid, minimizing the impact of social policy restrictions on the procurement process, increasing accountability within procurement management organizations, simplification of product specifications for commercial type products and greater emphasis on economically optimum quantities in procurement orders.

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* Excludes pension costs and indirect costs (e.g. office space).

While many initiatives in these areas have been proposed by the Administration, particularly by DOD, they have been consistently thwarted by restrictions and outright prohibitions in appropriations and authorization bills. Given both the gravity of the budget situation and the extensive list of procurement reforms proposed by the Grace Commission, a renewed major procurement reform effort in future budgets is both warranted and a promising opportunity for significant cost reductions.

8) Special Interest Economic Subsidies

Despite major progress in eliminating or reducing special interest economic subsidies over the past three budget rounds, substantial opportunities for savings still exist. The major obstacles are the natural, parochial political pressures to retain previously granted advantages, and the more compelling argument advanced by individual interest groups that subsidies should be eliminated across-the-board or not at all.

Fashioning a consistent set of federal policy standards against which to assess local, regional and industrial sector subsidies would be a difficult and demanding task. Yet an even-handed set of criteria fairly applied could produce billions in annual budget savings. A policy framework based on user fee principles and national vs. purely local or sectoral economic benefits could be expected to reduce outlays significantly in the following illustrative areas. Most of these have been previously proposed by the Administration, but not in the context of a comprehensive policy framework:

- capital and maintenance costs for inland waterways;
- operating costs of the FAA air traffic control system;
- search and rescue, inspection and licensing costs of the Coast Guard;
- capital and maintenance costs of deep ports;
- debt repayment and interest charges on outstanding federal loans to the federal power marketing administrations;
- large interest subsidies to rural electric and telephone cooperatives;
- operating subsidies for local mass transit systems and maritime operators;
- subsidized insurance premiums offered by the Pension Benefit Guarantee Corporation and many other federal insurance agencies;

- inadequate user fees for a variety of federal commercial inspection, liscensing and information services offered by USDA, Commerce, HUD, Treasury and many of the regulatory agencies;
- charges and fees for use of federal lands, parks and other facilities;
- subsidies for local economic development which merely shift the geographic location of investment and development such as those offered by EDA, HUD, Farmer's Home Administration, Corps of Engineers, and through such tax code features as industrial development bonds.

This partial list of remaining unwarranted economic subsides provides ample evidence that potential savings of billions per year are possible if an acceptable policy framework for subsidy phase-out can be developed, and intense special interest pressures overcome. To be sure, many of these proposals have been repeatedly rejected by individual congressional committees. Nevertheless, the overriding requirement for structural budget reform to bring future spending and revenues into alignment at an acceptable share of GNP necessitates that a comprehensive program to root out unjustified economic subsidies be considered in the next budget round.

IV. DEFICIT DOWN PAYMENT

Neither the spending control gains achieved thus far nor the wide range of opportunities for future structural reform are sufficient responses to the economic threat posed by the Federal deficit. Determined action is needed now to reduce the enormous gap between spending and revenues projected for FY 1985 and the years beyond.

Considerations of realism and practicality, however, suggest that actual implementation of modest measures to reduce the deficit now is the only viable course of action. It is virtually certain that protracted debate over sweeping measures to close the entire gap will result in no tangible action at all. Neither a workable political consensus nor an action-forcing crisis currently exists that would make grand solutions achievable during the limited time available in this session of Congress.

For these reasons the President has proposed a good faith negotiations process aimed at a down payment on deficit reduction. The 3-year, $100 billion target represents an estimate of what can be achieved on an expedited timetable based on a consensus menu of tax loophole and spending control measures that have already been extensively examined and generally endorsed by both branches, both Houses and both parties.

To be sure, achieving agreement on even these limited measures will not be easy or automatic. Compromise and flexibility by all parties to the process will be essential. In this spirit the Administration has indicated that all issues are on the table -- domestic spending, defense spending and revenue increases.

But the key to a successful outcome will be a disciplined focus on the less contentious items. There is no basis, for example, for an agreement on a complete long-term medicare solvency plan; but a variety of provider-oriented cost saving measures are included in both House and Senate Reconciliation bills and should be enacted. A new farm bill cannot be fashioned in the next month or two, but a freeze on target prices in return for adjustments in the 1984 commodity programs is a practical possibility.

Likewise, there is a basic division over the generic question of tax and benefit indexing, but COLA delays for civilian and military retirees and veterans comparable to the already enacted Social Security delay have already been endorsed by both Houses. Similarly, tax loophole closing measures such as restricting tax-exempt leasing or abusive shelters would produce desirable public policy improvements as well as additional revenues. But they avoid the re-opening of tax issues that have been already settled (such as the third-year rate reduction) or major new tax proposals that would be unacceptable to the American people.

In the defense area, the current Congressional target of $289 billion in budget authority for 1985 equals 95% of the Administration's $305 billion request. This 5% gap represents the same set of marginal differences of the pace and funding mix of the defense build-up that has taken an entire legislative cycle to resolve in each of the last two years. The President has indicated a willingness to reach an agreement in this range that is consistent with national security requirements and early, timely action on defense authorization and appropriations bills for 1985.

In sum, the $100 billion down-payment objective is both doable and essential. Without it, there exists a serious risk that the deficit will continue to rise beyond the current $180 billion level, exacerbating the threat to continued economic recovery and compounding the problem of reaching an overall solution next year.

With such a down-payment, the deficit level can be contained and possibly be reduced. To be sure, the down payment approach will not make the issue disappear, nor make the hard choices down the road any easier. But it would provide a clear signal to financial markets at home and abroad, and to the American people that the problem is solvable and that the Federal Government can and will act to responsibly manage the financial affairs of the nation.

Chairman **Domenici**. I have the sequence on the Democrats side. After Senator Chiles asks questions, if he has any, that we proceed with Senators Metzenbaum, Riegle, Johnston, Exon, Biden, and Sasser, based upon our understanding that we will proceed as we arrived.

On our side, Senators Symms, Andrews, Kassebaum, Gorton, and Quayle.

Now, I am going to ask only two questions, and then yield to Senator Chiles.

The President asked us to put together this bipartisan effort, Mr. Stockman, to reduce and enact budget savings. Is everything on the table?

Mr. **Stockman**. Yes.

Chairman **Domenici**. Will the President consider defense restraint over that 13 percent real growth which he asked for in his budget?

Mr. **Stockman**. That is something that he has obviously indicated that we would be willing to look at.

Chairman **Domenici**. Will the President support additional tax reform in the tax structure?

Mr. **Stockman**. Well, we have suggested in the budget a variety of loophole closing measures, and the invitation to a bipartisan negotiation. It was explicitly mentioned that raising revenue through closing loopholes, or making modest reforms in the structure of the code would be an appropriate item for consideration.

SUPPORT OF BIGGER PLAN UNLIKELY

Chairman **Domenici**. Will the President consider, and possibly support a bigger plan than $100 billion over 3 years—3½ years?

Mr. **Stockman**. I think everybody believes that if we could do more than $100 billion, then that is all to the better, and perhaps it will turn out that that is the case. But I think we all ought to recognize that we have gone through 1 year of complete stalemate, where we tossed huge plans back and forth that reflect the various philosophical and political positions that are represented in this Congress and in this country, and when we dealt with those big plans and those sweeping numbers we could not come to agreement.

And maybe some miracle will occur, some breakthrough will happen, and that will change this year, but I do not believe it for a moment.

But in the course of all of our debating, and the rhetoric that has gone back and forth, it has become clear that in the middle of the field, if we could use that analogy, there are items that have been debated and considered that are not staggering in scope, but nevertheless would do some good. They have either been endorsed or accepted or resigned to by a large portion of the Congress, by both sides and both Houses, and would be acceptable to the administration.

Now, I think this negotiation ought to start on the two 40-yard lines. We ought to sweep up everything that we can find in between, and make it the largest package possible. But if we are all going to start at our opposing philosophical goals, they we are not going to get there until next year and the problem is going to be a lot worse.

Chairman **Domenici**. Senator Metzenbaum.

TAX LOOPHOLES WILL BE LOOKED AT

Senator **Metzenbaum**. Mr. Stockman, in your Atlantic Monthly article some years ago, you enumerated a number of tax loopholes that could be looked at and indicated that you had suggested those, brought them up at White House levels. And in a subsequent hearing you and I discussed them, and I indicated you and I were not in much disagreement on them.

Would you still consider those major loopholes that ought to be put into the discussions stage, and would you support eliminating some or all of them?

Mr. **Stockman**. Well, I think as time has passed, the option that you originally suggested in our first hearing, that we take a look at some of the inequities and the holes in the Tax Code, has gained acceptance and attractiveness on the part of a lot of the people, including the administration. So we are going to be looking at that, and we will.

Now, that does not mean that every proposal that anybody has ever had by way of a tax loophole closing or a tax reform is valid or desirable or justified, but we ought to look at them.

Senator **Metzenbaum**. Would you tell us which, if any, you think bear high scrutiny by the administration, or any of those who would be involved in discussing the subject?

Mr. **Stockman**. Well, we have laid out a number of them in the budget, and I know that you have looked at those. Clearly, the practice that is now occurring, whereby tax exempt institutions, whether it is the U.S. Navy or colleges, are selling their property to investors purely for tax shelter purposes, that kind of thing we believe ought to be stopped and we have proposed to do that in the budget.

Senator **Metzenbaum**. Can you not do that by issuing a directive to the Secretary of the Navy, to stop doing it, because he has been the worst transgressor, and the Secretary of the Air Force was about to do it, I am not sure if he has——

Mr. **Stockman**. Well, I think the enthusiasm for that has slowed down, because it is fairly clear last year that almost everyone in Congress agreed that we ought to change that provision of the code.

The problem is, it is still there, and we need to get this passed. We have a whole variety of measures in the tax part of the budget for tightening shelters, in terms of all kinds of abuses that have occurred in the tax shelter area.

Maybe you will come up with more money, or different ideas, but clearly we have pinpointed that area in the recommendations we have made.

So I do not know that we are in disagreement. It is just an empirical matter now of what are the desirable things to do, and what can we get agreement on?

Senator **Metzenbaum**. As you well know, Senator Pryor and others, myself included, have raised the question in the past with respect to the use of consultants, and there has been some rather strong language used as to bailing out money at the end of the year to consultants, that former DOD employees went outside, got big consultant contracts, that the DOE spent 87 percent of its money on consultants, and it has always been a matter of concern to me that, as I understand it, the OMB signs off on any major speech that they make, I think that is right, policymaking speech.

Mr. STOCKMAN. Testimony.

PROGRAM UNDERWAY ON CONSULTING ISSUE

Senator METZENBAUM. Testimony. All right. The question that I have is, if you can find the time to do that, would it not be practical for the OMB to have to sign off on the hiring of any consultants, because the whole consulting issue relates directly to the question of whether a department cuts back on its employees, or fails to cut back on them. Some have claimed they cut back on the employees, and then went out and hired consultants to do the very same job, many times at 2½ times the cost. What are you doing about that?

Mr. STOCKMAN. Well, we have been pushing pretty hard on that issue since 1981, but I have to say that I have learned over the last 3 years that that is really a double-edged sword.

Senator METZENBAUM. A what?

Mr. STOCKMAN. That is really a double-edged sword, and we have to be a bit careful about how aggressively and indiscriminately we proceed. There have been countless examples of abuse by departments who have hired consultants, for no other reason than that they had money sitting in the pot at the end of the year, and wanted to spend it, rather than turn it back. But I think there is also a good case to be made that sometimes you can actually get a job done cheaper, that needs to be done, by going to the outside, getting a contractor to do it, than having people inside on the payroll on a permanent basis who may be needed only periodically.

So it is not as simple as saying let us just throw all the consultants overboard, or have OMB approve every one. There is going to have to be some balance in it, but where there is clear abuse, that a job is being performed that is not needed, a study is being paid for that has already been done six times, or that will not be helpful in resolving the question, then we need to move harder on that.

I want to tell you, it is difficult, down there in those big, $100 million salary and expense accounts, to find $25,000, or even $1 million they are spending for consultants that are not needed. It is very hard and I do not think it could be micro-managed by OMB. But we do have standards and we do have a program underway to try to control that, as best we can.

Senator METZENBAUM. You have indicated that there has been a reduction of 71,000 jobs since the President took office, but if you include the increases in the Department of Defense, and the increases at Justice, a few other increases, do you not come out——

Mr. STOCKMAN. About even.

Senator METZENBAUM. About even?

Mr. STOCKMAN. About even.

POVERTY LEVEL NOT AS BAD AS IT APPEARS

Senator METZENBAUM. Let me ask you one last question, and that is, you talked about the taxes are no lower today than they were in the past. But I think the real question is, who got the cuts, and do your figures not reflect the fact that today there are 5 million more—50-percent more millionaires than there were at the time the President took office, and that there were also 5 million more people living below the poverty level, than there were at the time the President took office?

Mr. STOCKMAN. Well, I would have to check those figures. I have not heard the first one. If there are, it could be due to the fact that we have had a boom in the stock market, the economy had its best performance in two decades last year, and some people made money as a result of the national economic recovery that we have had.

As far as the poverty level is concerned, yes, the counted numbers have gone up somewhat, but that began in 1979. It was due to the combined period of high inflation and a recession, in the 1979 to 1982 period.

The high inflation caused the poverty count to rise and the recession obviously caused the poverty count to rise, but I think that is turned around, and when the numbers are in for 1983 they will be down decisively.

Furthermore, in that count, as you well know, we do not include in-kind benefits, none of the $10 billion that we spend on housing, none of the $20 billion that we spend on medical care, none of the $30 billion that we spend on nutrition assistance, and other kinds of in-kind programs.

When you factor those in, the poverty level is still too high, but it is not as bad as it would appear from the simple statistic that is put out by the Census Bureau.

Senator METZENBAUM. Would you be good enough to furnish the committee with the facts with respect to both of my questions?

Mr. STOCKMAN. I would be happy to do that, Senator.

Senator METZENBAUM. Thank you.

[The following was subsequently supplied for the record:]

EMPLOYMENT LEVELS

In September 1981, President Reagan set a goal of reducing Federal civilian employment in nondefense agencies. As of September 30, 1983, the Administration had achieved reductions of 71,177 FTE's (full-time equivalents).

The total number of individuals employed in nondefense, non-postal agencies by the Federal Government was 91,717 lower on September 30, 1983, than when the Reagan Administration entered office. This reduction is partially offset by new hires at the Defense Department, which had had a net increase in employment of 57,751 since January 1981.

Only two other agencies show significant increases over this period. The Department of Justice added 2,206 law enforcement personnel, and the Veterans Administration added 4,089 part-time and intermittent health care workers.

NUMBER OF MILLIONAIRES; NUMBERS IN POVERTY

The precise number of millionaires in the U.S. is impossible to determine since data on the value of assets are not routinely available. Nevertheless, the number of millionaires should have increased because of inflation alone. Unfortunately, the number of people in poverty has also increased. The number of people in poverty increased by 5.1 million from 1980 to 1982 under the current poverty definition and was the result of the economic recession that was inherited by this Administration. From 1981, when the Administration took office, to 1982, the number of people in poverty increased by 2.6 million under the current poverty definition and by 2.5 million if in-kind benefits are included under the market value concept. The increase from 1980 to 1981 occurred under the Carter Administration.

Chairman DOMENICI. Senator Symms.

Senator SYMMS. Thank you, Mr. Chairman, and thank you, Mr. Stockman.

I think I came to the Congress the same time my good friend Joe Biden did, I was on the other side of the Capitol, and I appreciate what he had to say at the beginning of our hearing here this morning, but now the deficit has become the big target.

You know, as we in the political arena, it seems like 2 or 3 years ago inflation was a big target, and then we shot that duck down, and then the interest rates became a big target, and they started coming down, unemployment started to be the big target, and now it is the deficit.

But, unfortunately, we seem to fail to want to talk about what the real problem of the deficit is, and in doing a little research, I see in the past 53 years we have had 45 Federal deficits, and in the past 15 years we have had an uninterrupted deficit, every year.

And during that same period of time, and I note to my colleague from Ohio, Congress has increased taxes 193 times, and if you look at total Federal revenue, it is pretty hard to say that a lack of revenue is the cause of the deficits, when we think about it, when I came to the Congress the budget and revenues were around $200 billion, and now it is up above, close to six, $700 billion.

The Federal spending, as a percent of GNP, has grown from 18½ percent in 1960 to 20 percent in 1970, and 23 percent in 1980, and it is currently at 26 percent of the GNP.

SYSTEM MAY BE CANNABILIZED BY DEFICIT

Now, the problem, of course, is that we do balance the budget. We just go borrow the money, and the dilemma, I think, that the country is in, and I think it is a serious problem, and I agree with Senator Biden, I think we are getting ourselves in a situation where the deficit in our spending capabilities at the Federal Government may cannabilize the entire system, and we are witnessing the transformation of a Republic moving into a democracy, and not only that, we are witnessing a Republic form of Government that was based on a vibrant capitalistic economy transitioning into a socialistic type of an economy, which will never have the vibrance that a capitalistic economy has had, and what has provided us with all this growth.

So I share that concern, and I think it is absolutely essential that we tackle this thing from the standpoint that if we raise taxes, and it may be that there will be some of those, if we really got together in the backroom and settled the issue, but the question I would ask you, Mr. Stockman, is if taxes are raised, what competence would you have as Budget Director that it would not just remove the pressure from those in the political arena that are seeking reelection, to want to use those revenues, to continue to buy votes, as has happened in the past?

RAISING TAXES WILL NOT SOLVE PROBLEM

Mr. STOCKMAN. Well, Senator, I think there is always that risk, and always that temptation. I simply recall the unassailable facts of history over the late sixties and seventies. We did not have to vote to raise taxes then, we had inflation and bracket creep to do it for us. And taxes rose steadily every year, and more and more programs were created. So on that basis, I think your point can receive considerable validation.

But I would also observe that we are in a different situation today. I do believe that everyone recognizes that this gap that we have between our spending and revenues is so large that whatever revenue is raised, whether it is through tax loophole closings or otherwise, has to be dedicated entirely and completely to reducing that deficit, that burden on the financial market, and that threat to recovery.

Now, there are those around who, for other independent reasons, feel there are problems to be addressed, and want to spend money that we do not have. Well, whether there is additional tax revenue or not, I think they are going to be out there pushing those programs, but I think it is up to most of us here to resist them. We cannot afford any new initiatives, any new programs, and every dime that comes in under existing law or new law, has to be applied to reducing the deficit.

But I think the further point I would make is that we cannot simply raise taxes enough to pay for the existing spending that we have. That would be a staggering tax increase that would send the economy into the same kind of tailspin that would occur later if the deficits continue or rise. And therefore, we are going to have to chisel down, and shrink out, and sweat out even more. Until we can get an agreement to do both, then I think your basic point about simply going out and raising taxes is right. It will not solve the problem.

BREAK OUT BIGGEST BUDGET AX

Senator SYMMS. Mr. Chairman, I noticed, if you take a look at the 1983 budget, the fiscal year 1983 budget, we got along in 1983 which is only 2 short years ago with respect to the budget process and if we would just go back and spend the levels of spending that we did in 1983 we would still be spending $85 million an hour. This budget calls we spend $100 million an hour. It seems a little difficult for me to understand why a nation that can produce the kind of technology and the innovations and the success that we have seen and the opportunities for people should not have to sleep on grates, the opportunities are there better than any other country in the world, why it is that we cannot come to grips with this spending question. I find it very frustrating. That may oversimplify it but in my opinion we should start reducing the President's salary, the congressional salaries, and the salaries of all Government employees and all of those wealthy people who are receiving Government pension programs. If we would make a reduction across the board of 10 or 15 percent, it would go a long way toward setting the tone to solve this problem. And that may be oversimplification but I do not see any way that we are going to solve this problem under the current process short of waiting until we have the economic dilemma that we all want to avoid. I do not want to see this country cannibalized by the budget process but it looks to me like we are heading for it.

All I would say is Dave, break out your biggest budget ax. I was going to bring you in a chainsaw but I was afraid I could not carry one with a big enough engine to do the job that is needed, and give it to you this morning and with it go out and make some cuts on that budget. And I hope all my colleagues will do that too because short of that I think we are going to face serious problems in the future.

Chairman DOMENICI. Thank you very much, Senator.

Senator Riegle.

BUDGET HAS STOCKMAN'S SUPPORT

Senator RIEGLE. Thank you, Mr. Chairman.

Mr. Stockman, do you personally support this budget request?

Mr. STOCKMAN. Well, Senator, obviously I do support this budget. That is why I am here today to explain and present what is in it.

I think you recognize that I have a pretty unique post in Government, that I do my best in the internal process to make recommendations and put things together in a way that is plausible overall. But there are a lot of other voices and a lot of other considerations that are weighed from all the Cabinet departments, from the political advisers, and so forth.

So I would not pretend for a moment that every item, every component of this budget is what I would recommend, but when that process is complete my job is to support it. If you had this hat you would be doing the same thing here today.

Senator RIEGLE. But you support the package given, what you just said, you support this budget. It is obviously a compromise but you are here, you support it?

Mr. STOCKMAN. For 1985, Senator, I think that what is in this budget, as unpalatable as it may be in terms of the bottom line, is going to be about what we end up with even with a successful bipartisan negotiation. What is in it for the out-years is totally unacceptable to me and we are going to have to do a lot more. And I think you said you feel the same way, as do other members of the committee. But let us not say that this is the last budget, that this will freeze in things through 1989, some 6 years away.

Senator RIEGLE. So for 1985, the first year here, it has your stamp of approval; is that right?

Mr. STOCKMAN. Well, I am here presenting and recommending this budget.

Senator RIEGLE. Well, I know, but I am asking you a different question.

Does it have your stamp of approval?

Mr. STOCKMAN. Well, you——

Chairman DOMENICI. Do you have a stamp?

Senator RIEGLE. Mr. Chairman, it is an important question. I would like to get a straight answer and I think witness can speak for himself.

Chairman DOMENICI. I do not know that he has a stamp.

Mr. STOCKMAN. Well, Senator, I do not know what the conventions have been in the past. I cannot imagine that there has ever been a Budget Director who agreed with everything that was in the budget, even for the current year. So I think I stand in that tradition.

If you are trying to get a headline here which says that Stockman does not agree with the budget, I am not going to do that. If you want to talk privately about the things that might be changed, I would be happy to come by your office.

Senator RIEGLE. Well, it sounds to me like what you are saying is that you have some feelings that you do not think you can say publicly. I mean that is the impression that one gets from the comments you just made.

Mr. STOCKMAN. And I hope you do too. Because if we are going to solve this problem, you are going to have to be willing to agree to some things and discussion privately that you probably would not want to advocate here this morning.

Senator RIEGLE. But you are not prepared to say then that this budget for the coming year has your stamp of approval?

Mr. STOCKMAN. OK. Stamped.

Senator RIEGLE. So it does have your stamp of approval?

Mr. STOCKMAN. For whatever it is worth, yes. [Laughter.]

Senator RIEGLE. Well, that is the question. The question is: What it is worth and whether that is real. But I guess that is as much as I am going to get as an answer on that question.

CONGRESS SPENDING LESS THAN PRESIDENT ASKED FOR

Senator Domenici made an interesting observation a few minutes ago when he said that he had gone back and checked the record and sensed the first spending request by the Reagan administration up to the present time, that the President had asked to spend in the aggregate from the beginning more money than the Congress has actually acted to spend. In other words, that what the Congress has done since the inception of this administration in the aggregate is actually spend less in total than the President himself has asked for.

Is Senator Domenici correct in asserting that?

Mr. STOCKMAN. Well, he added numbers up to the trillions for a 3-year period, I believe, and if you do not take account of all the economic changes that have occurred on both sides of the budget, that may well be roughly correct.

Senator RIEGLE. We are talking total Government spending now. We are talking about spending, how much has been spent and how much has been asked to be spent.

Mr. STOCKMAN. Maybe I could ask the Chairman to clarify.

Did you base that 1984 to 1986 on the original March 1981 budget?

Chairman DOMENICI. Yes, sir.

Mr. STOCKMAN. Is it adjusted for the massive changes in economics that have occurred since then, interest rates, inflation and so forth?

Chairman DOMENICI. We will ask. I just asked for the numbers.

OK, let me correct the record. The numbers are not based on the original budget, they are based on the administration's fiscal year 1984 budget submission and the 1984 budget resolution with whatever the economic assumptions appended——

Mr. Stockman. Yes. Well, in that case, overall, everything added up, I think the point is close to being correct.

Senator Riegle. I think that is a very important fact and I think it is a fact that the public probably has not had before. Because I think the impression is that somehow the President has wanted to spend less money and the Congress spend more money. But the cold fact of the matter is that the President has actually asked to spend more than the Congress has agreed to spend since he became President, and that is a very important fact.

Let me move ahead.

Mr. Stockman. It was less than one-tenth of 1 percent though. That is correct. It is an important point but I would not carry it too far.

Senator Riegle. I think the impression at large in the public and one the President has in fact tried to create is that the Congress has spent substantially more than he had requested.

Mr. Stockman. I must say, Senator, I do not think the President or myself or anyone else has ever charged that the Congress has wanted more for total spending. We have been talking about domestic spending and I think you will agree with me that there has been a tendency for Congress to want to spend more for that purpose.

1985 COULD HAVE BIG RISKS

Senator Riegle. Well, it is important that the facts be put on the record, and I do think they speak for themselves. Now you mentioned a minute ago that even though your stamp of approval is on this budget, if something more is not done this year, by the time we get to 1985 the phrase you used, I did not get it all, although we could have the reporter read it back, that there were big risks that we would be running in 1985.

What do you see those risks as being?

Mr. Stockman. Well, there are two risks, obviously. And they are not profound statements.

One is that if we fail to come to any kind of agreement this year, as we did last year, that even the $180 billion number in our budget may not materialize because it assumes 8 billion dollars' worth of tax loophole closings that would not happen and $6 billion or $7 billion worth of domestic spending changes that would not happen. And it seems to me that in the third year of the recovery you are pressing your luck very hard if you end up with something in the range of a $200 billion deficit. So the risks the recovery could slow down or weaken, would rise substantially.

The second point is the political risks. It is going to be hard, given the philosophical differences between, for instance, my friend from Idaho and your colleague from Ohio, for the Congress even if a great upwelling of statesmanship occurs early next year after the election, to put together a package that begins to reduce that gap enough to insure that the economy keeps moving along.

But if we do nothing now, the package will have to be just that much bigger, the freight on the wagon will be just that much greater, and the size of the problem may well be larger if the economy is faltering. I do not think the wagon could carry that much freight and it will be better to do it in two or three stages. Let us get a down payment now, let us do what we can to increase the probability that the economy will be moving along, and reduce somewhat the size of the bite that we will have to take next year.

That is my analysis and I think a lot of members on both sides here in the committee agree with it.

Senator RIEGLE. Well, I would like to pursue that maybe in a second round.

Let me just ask you this question.

FREEZING NONENTITLEMENT PROGRAMS

If we were to set entitlements aside and just take the non-entitlements side of the budget, and if we were to take the status quo only add to the budget enough to compensate for the expected inflation so that we held everything at its current level in real terms, and then imposed a freeze in nonentitlement spending, could you support that?

Mr. STOCKMAN. Let me just restate to make sure I am clear. A freeze in nonentitlement spending is what you——

Senator RIEGLE. Yes, adjusted only for inflation. In other words, we would hold all nonentitlement spending harmless in terms of inflation.

Mr. STOCKMAN. Well, that is essentially what we have proposed in the budget. It is on page 3 of my testimony.[1]

Senator RIEGLE. Well, that would not be true for Defense.

Mr. STOCKMAN. No, I thought you were talking—well——

Senator RIEGLE. I am saying—well, do not tell me Defense has become an entitlement? I know it seems that way but I would like to think that it has not. Whether I am including Defense obviously in the nonentitlements——

Mr. STOCKMAN. I do not think that there are any members of the committee that would agree to a freeze on Defense.

Senator RIEGLE. No, that is not what I asked. I asked is that something that you could accept as a responsive way to deal with the deficit hemorrhage here?

Mr. STOCKMAN. I do not believe it would be possible even if it were desirable.

Senator RIEGLE. But we do not know what is possible right now.

Mr. STOCKMAN. I am saying it would not be technically possible to hold Defense outlay growth to 7 percent or 4 percent if that is your inflation rate, because we have already made enough decisions here last year and the year before in the appropriations bill, to cause the growth of outlays to exceed that on the basis of prior authority.

Senator RIEGLE. So Defense is not only out of control but it is out of control in a way you are saying now we cannot do much about it?

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[1] See p. 28.

Mr. **Stockman**. Well, no——

Senator **Riegle**. That is——

Mr. **Stockman**. That is something that we can do but we have to work within a frame of feasibility.

Chairman **Domenici**. Senator, your time has expired.

Senator Andrews.

HALF OF DEFICIT IS INTEREST ON DEBT

Senator **Andrews**. Thank you, Mr. Chairman.

Dave, a minute ago you asked what the wagon could carry or you stated that it is about time that we look at what the wagon could carry.

We are all wrapped up in this $200 billion deficit and everybody, whatever side of the aisle they are on, or whether they are downtown, say that we have to do something about $200 billion deficit. And then everybody immediately forgets that half of that deficit today is made up in interest on the debt that we have accumulated from prior years and the budget that you are bringing to this committee today increases the deficits so much that the debt will be increased over the next 3 years to the point where we will have another $60, $65, $70 billion a year or one-third of our projected deficits, to pay in interest on that added debt that you propose to add during the next 3 years.

Where do we get to this point of how much can the wagon carry? Do you ever expect the net interest share of the total budget to start a steady decline?

Mr. **Stockman**. Senator, I think that could happen if we put in place policy measures to close the gap between spending and revenues. I mean that is just basic math, that is very obvious.

When I said what the wagon could carry, I do not think I was referring to how much deficit we could stand. I was referring more to how much a majority of the House and Senate could agree to do that would reduce it. I was speaking politically and we have to face the fact that that is an essential ingredient in the equation. Everybody has their own plan. I have noticed that every plan proposed balances the budget. The problem is that it will be from now until the next century before you get 50 people to agree to any one of those plans in this body.

Senator **Andrews**. The trouble is, Dave, we are talking about your budget proposal or the President's budget proposal, whichever we define it, whoever has which stamp of approval on it. Some place along the line we have to also decide whether we are going to do something about it now or whether we are going to hide our collective heads in the sand and wait until after the election at which time almost every economist worth his salt has testified before this committee and said in the press that it is going to be that much tougher to resolve 10, 12 months hence.

Do not you believe that it is going to be that much tougher to resolve in 10 or 12 months?

Mr. **Stockman**. Yes, absolutely. That was the whole point of my discussion of how much the wagon can carry.

HOLE GETTING DEEPER AND DEEPER

Senator **Andrews**. That is right, but this budget does not resolve that. This budget anticipates adding to the debt load or the load that is in that wagon so much that we will have to pay an additional $70 billion interest on the national debt 3 years hence or one-third of the projected deficit.

Now, does not that kind of antic, that kind of loading the wagon give us the danger of these higher interest costs offsetting the spending restraints that we might enact?

Mr. **Stockman**. Well, there is that danger there. It is a serious one, but as a practical matter the net interest that we are projecting for 1985 is $116 billion and by 1989 it is $126 billion. And that is due to the excessively and unacceptably high deficits that we have in the out years.

It is very obvious to me that if we reduce this built-in imbalance in part now through this down payment negotiations process and in larger measure next year, that net interest can easily fall below $100 billion in 1987 or 1988. That part of the self-feeding problem can be unwound quickly if we are willing to take the steps. We can make it work for us if we take action. If we continue to debate, if we continue to have a stalemate, it is going to work against us in precisely the way that you have laid out.

On a current services basis, net interest could easily hit $160 to $180 billion in the late 1980's and I do not think there is anybody on this Committee who could think of enough taxes to raise or enough spending to cut to even offset that explosion of debt service cost. We are in the same position that many companies are in when they are on the eve of chapter 11.

Senator **Andrews**. So the combination of this head in the sand attitude and these rosy economic predictions we are getting ourselves into a deeper and deeper hole all the time and one that we ought to address now instead of after the election. You agree to that?

Mr. **Stockman**. And that is why we hope we can get something done in these down payment discussions.

PROCUREMENT GETS 80 PERCENT OF NAVY BUDGET

Senator **Andrews**. Mr. Director, also a large part of this budget is Defense spending increases and you have said that they are inevitable as a result of programs that have been set in motion during the past 3 years.

Can you honestly say that there are no major weapons systems that could be cost effectively halted?

Mr. **Stockman**. Well, I cannot say that I am any expert in that or that it would be appropriate for me to sit here and testify. I only note that I believe in the authorization committee and the appropriations committee of this Congress. The best collective expertise that you have, sits on those committees for hours and hours and they have not cut one weapons system that we have proposed in the last 3 years. Now, I do not always agree with what a majority of the Congress concludes, but in this instance you have to accept that as some evidence that these systems were needed.

Senator **Andrews**. We have come close, Mr. Director, but the point is that a recent GAO report has been quoted as saying that only 8 of this Nation's 14 aircraft carriers are ready to go to sea in a combat basis within 2 or 3 months. Yet we find in your budget request you have been asking for 80 percent of the increases in the Navy budget going to procurement, a big weapons systems; and only 15 percent for readiness.

Why in the devil do we need to keep adding major weapons systems when the systems we now have are not ready to go? Would not we be better off, could not we save money, could not we be better defended, more prepared to defend our freedom if we spent some of this money on making sure that those six carriers that are not ready to go are ready to go?

Mr. **Stockman**. Well, I think that is a good point but I do note that in each of the last years the appropriations committee has cut more out of the O&M and readiness accounts than it has out of the procurement account. So that would seem to be a problem that all of us ought to think about since we have made recommendations and Congress has disposed in a similar manner.

Senator **Andrews**. OMB gets into these major trends within other agencies, why do you get bashful when it comes to Defense? And I am not talking about cutting our defense preparedness. I think we could increase it by using some common sense and that is what you folks are doing or supposed to be doing down there at OMB, finding the major trend lines that we ought to follow so that we get more bang for our buck or more education for our buck or more farm programs or whatever for our dollar.

Is that not what a budget officer is supposed to do?

Mr. **Stockman**. Bashfulness is one thing. Efficacy is another. I have not been lacking——

Senator **Andrews**. Ain't nobody ever accused you of being bashful. I think that given the fact that Cap Weinberger and his crew do not seem to be able to get a handle on tying readiness with cost effectiveness, do not seem to get a handle on being commonsense, maybe you could inject a fresh new wave of commonsense budget operations down in that department. And we will have an opportunity to explore this I am sure with Cap when he comes up next week.

I appreciate it, Mr. Chairman.

Chairman **Domenici**. Thank you very much.

Senator Johnston?

POSITION OF BUDGET COMMITTEE

Senator **Johnston**. Thank you, Mr. Chairman.

Mr. Stockman, I am sincerely sorry that your recommendations through the years voiced in the internal process which you have described have not been recommended. If they had been, I am quite sure that we would not be in the mess that we are in. And I really am confident that you have a great deal more sense than is reflected in this budget.

Now, having said that, I am worried about how we get here to there and especially about how we—what the place of this Budget Committee really is? Whether we are—have been made to be somewhat irrelevant to a large extent by the Executive. And I call on the experience of last year where after we went through that wrenching process, got a budget that I did not particularly agree with in all respects, but at least which the Congress and the Executive agreed to. I remember going to a breakfast with Cap Weinberger and saying to him, you know, Mr. Weinberger, we agreed to 5 percent defense increase and that amounts to so many dollars, and we would like your guidance. This was the Defense Appropriation Subcommittee, we would like your guidance as to how we fit your budget into the administration's agreed figures.

And he launched off into a speech about how the Russians are coming and the threat and we said, well, you do not seem to understand the administration has agreed to these figures and we need your cooperation as to how you would advise cutting. And he proceeded to tell us again how the Russians are coming. And, indeed, the appropriations bill that finally passed did not reflect the budget resolution but rather reflected his appreciation of the threat.

Now, my question to you is: What is the position of this Budget Committee? Will the administration live within whatever we finally come up that goes through both Houses of Congress or are we somewhat irrelevant?

BUDGET COMMITTEE LOOKED TO FOR LEADERSHIP

Mr. STOCKMAN. Well, I would never suggest that this Budget Committee is somewhat irrelevant. I look to this Budget Committee to provide the leadership in this Congress that will eventually allow us to make some progress; some now, more later.

You people on this committee understand the problem more thoroughly and also the political dilemmas in moving forward better than the rest of the Congress combined, so it is up to you. And I would never suggest that you are irrelevant. You are our only hope in some basic sense.

Now, an unfortunate thing happened last year. The process was launched with a very provocative political budget that was ramrodded through the House and that began a cycle of charge and countercharge and politicization that resulted in the Congress going one way in its budget resolution and the administration going another way. We saw the result of that, no matter how the blame now can be distributed in hindsight. The result was that nothing was accomplished at all in substantive terms last year to deal with this problem. I think that is one of the reasons why some of us recommended that the President take the risky and somewhat unusual step of making in the state of the Union an invitation to the leadership of the House and the Senate to sit down and start negotiating before somebody throws a bomb in the eyes of somebody else that leads to a breakdown of the kind we had last year. That has now started and it seems to me that if we can all keep that going this Budget Committee will be crucial, because it may be that you now have one representative of the Democrats in the Senate and one in the House, but once we get down to the nitty-gritty of working out a dozen or two proposals that will add up to this package, we are obviously going to need you and the others. And on defense matters, we have indicated that $305 billion is not chiseled in stone.

But let us not start with an enormous exaggeration of our differences. The fact is your budget last year provided $289 billion in budget authority for DOD in 1985. We are at $305 billion. That is $16 billion difference. It is a 5-percent difference. And I would plead with you not to focus on the real growth rate which depends on your inflation assumption; you say 5 percent based on CBO assumption of higher inflation, and we say 13 percent based on lower inflation. The important thing is the $16 billion difference and how much of it we have to have that you might be willing to go along with, and what we do not have to have.

NEW BIPARTISAN COMMISSION

Senator JOHNSTON. Well, the point is this. I do not mean to argue the Defense budget at this time. I wish I had time to do it.

What is the place of this Budget Committee? I notice for example that we are talking about a new bipartisan commission which frankly I find just a little bit offensive when you consider the expertise accumulated on this Committee, staff support we have, the experience through the years in dealing with these things. And now we are talking about a new bipartisan commission.

Mr. STOCKMAN. I do not think anybody has proposed a commission. We have proposed a process of negotiations with the fiscal leadership of Congress. But I think everybody recognizes that the fiscal leadership of Congress will fail unless the ultimate elected leadership of each body endorses what is being done. So we have gone directly to the Speaker, we will start from that level. But obviously when the real work of putting things on paper and adding things together gets under way, I expect it will be the Budget Committee members and the Finance Committee members who will be doing the work.

RESTRUCTURE COMMITTEE

Senator JOHNSTON. Can you tell me candidly whether you think we ought to restructure the committee so as to include some organizational input from Finance and Appropriations? Have you given that any thought?

Mr. STOCKMAN. Well, I am not sure of the procedures in the Senate, being a creature of the House. The House is structured so that the Appropriations, Ways and Means Committees are represented on the Budget Committee.

Frankly, I believe that there should be more representation in an institutionalized sense from the committees that can originate the taxes and control the spending, and I think you have named them.

ADMINISTRATION HAS DONE ALL IT CAN TO REDUCE SPENDING

Senator JOHNSTON. All right. Let me ask you another question now.

My hometown newspaper, The Shreveport Times, had an editorial the other day which said, in effect, that the administration has done all it can to get the deficit down, that it is all the Congress fault with a 5th year binge of spending. And having been here and seen the logical choices made to increase defense, cut taxes and all that, is The Shreveport Times right that the administration has done all it can to get spending down?

Mr. STOCKMAN. Well, if we want to get into a sort of cosmic assignment of blame.

Senator JOHNSTON. Yep.

Mr. STOCKMAN. I do not think we are going to get very far.

Senator JOHNSTON. You cannot say yes or no?

Mr. STOCKMAN. I believe there are some times that we should have bitten the bullet that we did not. I will not necessarily itemize those here this morning.

RATIONAL CHOICES

Senator JOHNSTON. This election is not going to rise or fall on that one question, but it is the kind that gets me. The answer to that is plainly no.

Have you made some rational choices? Increase defense? I mean I read in the Fortune magazine where you say the President's big mistake in 1981 was failing to roll over the big old social insurance programs, COLA's, medicare, foreign programs, et cetera. Has the administration made rational choices which are not to cut spending which could have been done?

Mr. STOCKMAN. I think that is a fair statement. Under the circumstances, as you saw them then, or as I may have seen them, you make choices and it turns out the circumstances are different than you expected at the time.

In 1980——

DEFENSE CUTS NEXT YEAR MAY BE TOO LATE

Senator JOHNSTON. That is enough cosmic blame putting for awhile.

Let me ask you this.

I worry about when we get around to this point, whenever it is, whether it is this year or next year, and I fear that it is next year to make all these cuts, that it is going to be uncommonly difficult starting with defense, because we have all these big programs put under contract, and I worry that maybe this—maybe we need to move this year because next year may be too late. I recall, for example, on the two carriers which were put under contract and who was it who wanted to come out and stop those, and they found out they were too far along that it would almost cost more money to stop them than to continue. I worry that that is going to be the case in all these other weapons systems. I have looked at the figures that in 1977, 24 percent of the defense budget was in procurement, this year I believe it is about 30 percent. By 1987 it goes up to 38 percent. From 24 to 38 percent, the percent of the defense budget is in procurement. And once those things are procured and the keels are laid and the workers are hired and the lines are moving, you cannot stop them.

Do you share that great fear about cutting defense? It has to be cut. And maybe we should start trying to do that this year.

Mr. STOCKMAN. Well, I guess up to this point I would agree with you. I think our problem is we are unwilling to live with the consequences of decisions that we make, and that is true of everybody.

But in the case of your example, when we approved those two carriers in 1983, we made a big decision. That decision was not just for the two carriers that cost $3 billion each, but it was a decision to have 15 carrier battle groups as the basic force structure of our surface fleet, and those were ordered, they were appropriated, that strategy was validated by the Congress. There was not a biq fight over those carriers except for a small rear guard action in the House. Now that you have them underway and you have that strategy unfolding, you not only need to pay the $7 billion for the carriers, but you need to put F-14's and F-18's on their deck, you need to outfit them with the whole complement of ships from oilers that do not cost much, to Aegis ships which cost a billion dollars each, in order to permit them to carry on the function they were designed to do. So we made a big decision then over the force structure of the Navy for the entire decade, and we are going to have to spend the money that is needed to put carrier planes on the decks and to put missiles on the planes and to put the complement of ships on the seas that will be needed.

B-1 BOMBER DECISION

Senator JOHNSTON. I am not getting at the carriers themselves. I am talking about those other kinds of decisions being made now, like the B-1 bomber.

Mr. STOCKMAN. Well, that decision has already been made. Congress gave us two orders in 1981, and we debated that, they said, yes, we need a new strategic bomber and it has to come in at under $20.2 billion. There is only one way to do that and that is to build it fast, and that is one of the reasons why the budget is going up this year.

Senator JOHNSTON. That cannot be stopped?

Mr. STOCKMAN. If we slow down the B-1, the unit cost will explode and the injunction from Congress not to exceed the $20.2 billion cost for the 100 planes will be shattered. That is why the budget is going up because we are implementing the program in this instance under the terms by which it was overwhelmingly approved.

Senator JOHNSTON. You do not really believe that $20.2 billion ceiling, do you?

Mr. STOCKMAN. I believe that people were pretty serious about trying to bring it in at that, and I know that technically unless you build them rapidly in terms of the size of the annual buy and the production run, there is no way you can achieve it. We are trying to achieve it by mid-1986 which is what it would require to stay close to that ceiling.

DEFENSE DEPARTMENT RECOMMENDATIONS

Senator KASSEBAUM [presiding]. I am sorry your time is up.

Since I have taken over, there is nothing like saying I am next. I will be very brief because actually Senator Andrews pursued the line of questions that I had in mind.

I would only say, Mr. Stockman, that you have been a very honest and diligent broker for the budget. And following along a little more specifically perhaps in what Senator Andrews was asking, because you have used a sharp pencil on everything from aviation to rural electric co-ops, and I wonder what specific recommendations have you made for the Defense Department in some initiatives that they could undertake that would be helpful to them in a realistic forecasting, both I think regarding underfunding as well as overfunding their budget?

Mr. STOCKMAN. Well, again, it is difficult to get into the whole range of private recommendations that I may have made, but I would refer you to the Grace Commission report because I think they have not raised policy issues there, what kind of force structure, missions, and so forth. Rather, they have raised a lot of issues regarding the contracting process, the management of inventories, the procurement process, and so forth, that I believe the Defense Department should look at quite carefully since these were industry experts that made these recommendations and they were not made lightly. Hopefully, they will save some money in the years ahead.

Now, there is a whole list there, a huge roster. Some of them are not practical, frankly, but there are a lot of things in there——

Senator KASSEBAUM. Like closing all of the commissaries?

Mr. STOCKMAN. Well, that is the one I like the best. I am probably the only one that likes that, because I cannot for the life of me understand why we need to perpetuate a 19th century relic in the age of Giant and Safeway. But there are others who would have a different view on that.

But even in the defense area, I guess the thing I would like to say is if you want to save money, you have got to bite bullets that the Congress has not been willing to do thus far. We could save money if we closed bases. You know what the record is on that. We could save money if we could contract out some of the work that is done by either civilian or uniformed personnel. Every time we get an authorization or appropriation bill, there is a rider in it which says that A-76, the contracting-out procedure, shall not apply to this or that activity of the Department of Defense. We could save some money if we would reform the retirement system, but we do not seem to be getting very much enthusiasm about that up here on Capitol Hill either. I could go on down the line, but it seems to me it is one thing to throw a number up in the air and to swing a pencil wildly and say this is how much should be cut. When you start laying out the items, the line item changes, that is where it gets tough, and I would hope we could see more forthcoming attitude from this side of the equation as well as ours.

Senator KASSEBAUM. But I would go back to many of the other programs which you have been very firm in saying these were changes that had to be made within those agencies.

Will you take—and I have looked at the Grace Commission, and I think we all have, particularly in the defense area, will you make recommendations and say to the Defense Department these are things that should be considered or to use up here? True, the pensions I think some very good recommendations have been made, but beyond that, whether we have not gone very far or really we have not gotten some realistic recommendations that have been—you have been firm on or the Department of Defense has been firm on. You know, I think actually our own funding mechanism for DOD is not wise, the B-1 being a good example.

Now, I think we had 20 votes on that one way or another in the 5 years that I have been here, and some years it carries and some years it does not. But I think these are specifically some areas in which you could make some very useful suggestions for changes in procedure, whether it is procurement or contract to be used.

Mr. **STOCKMAN.** I guess I could just respond by saying that my basic job, my charter is to tell people things they do not want to hear, and I do not intend to exempt DOD from that line of responsibility.

CONSTITUTIONAL AMENDMENT TO BALANCE BUDGET

Senator **KASSEBAUM.** Let me just ask one other question, Mr. Stockman.

Do you believe a constitutional amendment to balance the budget is the answer to our budget problems?

Mr. **STOCKMAN.** Well, I think it is one answer, but that obviously is going to take a long time to get enacted. I do not think that we obviously have the luxury of waiting until a constitutional amendment is ratified to address the problem. Maybe if we can finally get our act together and get this job done and the deficit balanced by the end of the decade, it might be good to lock it in with a constitutional amendment so that it never gets out of hand again. So, therefore, in that sense it is a good idea and it is one that has been recommended by the administration. But it is not a substitute for the hard choices that we have to make now.

Senator **KASSEBAUM.** Just out of curiosity, if we make the hard choices and balance the budget, having an amendment then that we would enact, what would that do?

Mr. **STOCKMAN.** Well, I think it would avoid us the temptation forevermore of doing what we have done, as I think it was Senator Symms or someone noted 45 out of the last 50 years running a deficit.

Senator **KASSEBAUM.** Thank you very much.

Senator Exon, I think you are next.

PROPOSED DOD BUDGET HIGHER

Senator **EXON.** Madam Chairman, thank you very much.

David, welcome back. We are glad to have you, and I recognize you are in a very difficult position this morning, and I hope that you will not think that the questions that I am about to ask you will make it more difficult.

I just think it is important that we have a bipartisan approach to solving this problem, and I think you know far more about this budget. I just wish that the thought that you and people like you in the administration would come to the fore a lot more than they do.

On the budget, let me ask you a question about the defense budget, which has increased by 13 percent with this document, to an overall total of about $305 billion. Was there originally proposed a higher amount than this by the Department of Defense.

Mr. STOCKMAN. Yes.

Senator EXON. How much higher?

Mr. STOCKMAN. Seventeen billion higher. Our budget last year, that we submitted for 1984, contemplated defense budget authority of $322 billion in 1985. We have reduced that by $17 billion, brought it down to the $305 billion request that we are now making. That is in part due to the fact that in 1984 you lowered our request from 273 to 258, so we are behind about 15, and now the same debate occurs again this year.

Senator EXON. This higher figure, was that considered within the last few months as a possible figure for inclusion in this budget?

Mr. STOCKMAN. Well, I think it was carried in the books.

Senator EXON. Well, I am not talking about in the books. I mean did the Department?

Mr. STOCKMAN. I mean at the Department, that was the planning figure they used, because they were waiting to see what would be the outcome of the appropriations bill. Once the appropriations bill was finalized, it was pretty clear where we were starting in terms of 1984, and on that basis, the number was adjusted.

Also, we have discovered that the inflation rate for 1985 and out would be somewhat less than we were planning last year. So there was the possibility to squeeze some dollars out of that prior year figure on that basis.

Senator EXON. The Secretary of Defense testified in front of the Armed Services yesterday that they did not propose a higher figure than $305 billion. Is that accurate or not?

Mr. STOCKMAN. In terms of what came over to the White House as the final DOD recommendation, that is absolutely correct. His recommendation was $305 billion.

I think what you are referring to is in the internal DOD process over the summer and the fall, before they knew what the appropriations bill would be, they used a target of $322 billion, but I think everybody there recognized, as a realistic matter, that that number was not going to stand.

BALANCED BUDGET AMENDMENT

Senator EXON. All right. Let us go on to some other matters now, because the time is very short.

Is the President still for the balanced budget amendment? I supported that. Is the President still for the line-item veto measure? I have supported that as one of the few on my side of the aisle. If he does, why does he not act in a more—more of a leadership role, in exercising restraint?

We do not need a balanced budget amendment that requires the President send us over a balanced budget, which he certainly has not.

Does it not make a mockery out of the President's frequently quoted statement that he is for a balanced budget amendment, when he sends us a budget like this?

Mr. STOCKMAN. No, because he actually believes that having that kind of tool, that kind of action forcing mechanism in our constitutional structure, would have resulted in action far greater in magnitude than we have taken thus far.

As long as all constituencies can be protected, as long as all easy choices can be avoided, and we just charge it up to a deficit, or to Senator Metzenbaum's card there, then we end up in the predicament, as disagreeable as it is, that we are in today.

If a constitutional amendment had been in effect these last couple of years, we would not be here having the argument that we are having today.

Senator EXON. And that is justification for the——

Mr. STOCKMAN. That is justification.

Senator EXON. That is the justification in your mind that the President is not required to submit a balanced budget?

Mr. STOCKMAN. No, I was saying that there is not an inconsistency between the view that institutionally a constitutional amendment would be a powerful force for the better in the actual budget that we submitted this year, which basically reflects all decisions that are made or not made for 3 years.

That does not justify the deficit, it is just a fact of life as to where we are, because we did not have that mechanism in place. And beyond that, in terms of the leadership issue, I think is an invitation to sit down and negotiate at least a down payment package, his clear statement——

Senator EXON. His last minute suggestion.

Mr. STOCKMAN. Well, I do not know how we measure minutes, but it was always——

Senator EXON. It was the day of the speech, was it not?

Mr. STOCKMAN. Well, the first event of the legislative year is the State of the Union Address. So he proposed it in the first day, and the first hour. I do not know how much more timely you could have been.

Senator EXON. Thank you.

Mr. STOCKMAN. Now, when it was decided is another matter.

STIMULATING ECONOMY ACCOUNTS FOR GOOD TIMES

Senator EXON. We hear a lot of talk today about the good times, and the roll that we are on, I can assure you that in Nebraska we are not sharing evenly or equally in the economic recovery.

Let me ask you this. Do we not always have good times in our economic history when we stimulate the economy through massive deficits? Has that not generally been our history?

Mr. STOCKMAN. Well, I think in a very short-run sense, you probably could link the two, but there has always been a price to pay afterwards.

Senator EXON. Exactly. Have we not also generally had good times when the economy was on a war time footing, which no one can argue that it is on right now?

Mr. STOCKMAN. Well, I do not know. We have had a huge surge in production, but in World War II there was a scarcity in terms of the standard of living that everybody was on; all the money went to the war effort.

Senator EXON. I know, but everybody did very well economically during that period. We had the GI bill, and everything else, to make up for those who went to service.

And third, have we not always enjoyed good times, and have not the good times rolled, when we stimulate the economy with a massive tax cut?

Mr. STOCKMAN. Well, I think there is evidence for that proposition, too.

Senator EXON. So do you not agree that the main reason, that good times are rolling today is that we have had all three of those stimulants, in effect, and therefore it is not amazing that the good times are rolling, supposedly right now. Is that not the main reason for the supposed upturn in the economy?

Mr. STOCKMAN. Well, we could get into a long economic discussion here, but I am not sure it would be worthwhile. I think a lot of good things have happened to the economy, that account for the good times.

One, we bit the bullet on monetary policy, we stopped the growth of excess money in credit creation, it caused pain in the economy for a while, but clearly we have succeeded beyond anybody's wildest imagination in wringing the inflationary psychology, the inflationary fact, and the inflationary cost structure out of our economy.

Now, that is part of the reason for the good times. Productivity is surging now, because some very difficult cost-cutting steps were taken. Look at the automobile industry today with the profits that were generated in the last two quarters, compared to the way it looked in 1979 and 1980 when it was flat on its back. There have been more than just transient responses to what you might call the stimulus of these items you have named that have occurred in the economy. They can have lasting value, if we can maintain a fiscal and monetary policy environment that is supportive.

Some of these things are real and lasting and permanent, and I guess our job is to make sure that they are not impeded by letting things get out of control, and I do not think we disagree on that.

Senator EXON. Madam Chairman, could I have another 30 seconds? I am sorry.

Senator KASSEBAUM. Only 30 seconds.

PRESIDENT'S BUDGET RECKLESS

Senator EXON. I did not make an opening statement that I wanted, and I was not recognized.

Just let me say, David, that I happen to view this budget presentation as not only reckless, but ruinous, and I think it is a prescription for sheer financial disaster.

Now, Mr. Feldstein and others have said as much, Feldstein said yesterday, I think that Democrats and Republicans want this matter resolved. I think that what is going to happen is that we are going to have deficit reduction only if we have a bipartisan approach.

It seems to me that we do have to have a bipartisan approach. But I think that before we have a bipartisan approach, or a commission, and I probably will move at an appropriate time to tie this whole thing up in a big red ribbon, and send it right back to the President, and suggest that that commission only start working on this until the President has furnished a leadership to provide us with alternatives that he wants, rather than the phony plan that you have sent over.

I thank you, Madam Chairman.

Senator KASSEBAUM. Senator Gorton?

SUCCESSFUL CHANGES IN EMPLOYMENT, INTEREST RATES, AND INFLATION

Senator GORTON. Thank you, Madam Chairman.

I suppose, after sitting here this morning, Mr. Stockman, no one should be surprised that in 3 years you have already served in this position longer than anyone since the wartime administration of Franklin Roosevelt. The job obviously requires a great deal of patience, as well as dedication and skill, and before I start out, I want to say that you have exemplified those qualities, as far as I am concerned, during my 3 years here, to a very, very high degree.

I think the reward, in spite of all the criticisms, which you can reflect on, as a result of your tenure, are that you have effected great change, most of which has not been referred to here this morning at all.

You and your policies have certainly been associated with a dramatic victory in the war against inflation, and you just referred to that in an answer to Senator Exon.

You have been successful, although not quite as successful, in reducing interest rates which, unpleasant as they are, are certainly much lower than they were when you began this career, and you also have been associated, in the last year especially, with sharp declines in unemployment which have obviously benefitted not only those who have gained new jobs, but the whole United States.

The problem is, of course, that any kind of success, even partial success, simply leads to another challenge, and all of the expressions here, whether they have been friendly or unfriendly today, are directed at huge budget deficits, because I think implicitly everyone here, yourself included, believes that they threaten all of the triumphs which we have had in the last 3 years, employment, interest rates, inflation, and the like.

I did not, as Senator Exon did not, have an opportunity to make an opening statement. If I had, it would have been to praise, and to reflect on the position taken by Senator Biden, who expressed the view that this is the kind of problem, the kind of challenge that we can only meet by working together, and also that it is a challenge which we must meet today.

BALANCED BUDGET FURTHER IN FUTURE

As I suspect you know, beginning with my second year here, I have gone through the exercise each year, after you have come up with this budget, of coming up with an alternative. In 1982 it was fairly easy, at least in theory, to come up with an alternative, which 3 or 4 years down the road resulted in a balanced budget.

A year ago, it was really possible to do that only by playing with mirrors. It just, as a practical matter, could not be accomplished.

Now, no matter what any of us propose here, anything like a balanced budget seems even further in the future. In other words, the longer we delay dealing with these problems, the more difficult they are, and if we leave them until 1985, they will be much more difficult than they are in 1984.

So I should like to say, that while I am very dissatisfied with this budget, at least I can express a delight that the President has been willing to say that it is time for us to begin to work together, and at the very least to make a down payment on that budget deficit; a down payment which I do not think is enough, but it is certainly much better than starting from a point of confrontation.

And in order to try to move on toward some success in dealing with that problem, I have in the balance of my time, some rather specific questions to you about this budget.

ECONOMIC ASSUMPTIONS

First of which deals with the economic assumptions which accompany it, and which show a constant decline in employment over the entire period for which it makes predictions, constant decline in interest rates, and no significant reigniting of inflation. That obviously on the surface of it does not seem to be consistent with budget deficits, which even in this document, are well over $100 billion a year, and which most of us feel would be much higher than that if we do not deal with them more decisively than this budget seems to do.

You did make a presentation yesterday, and I would like to know whether or not it is correct, that the assumptions of interest rates and unemployment, and inflation are based not on what we might call a business-as-usual kind of budget, but on the proposition that we are, in fact, going to make a down payment on that deficit this year, and do something even more dramatic to reduce budget deficits in the other years, which this budget covers, rather than just go on as we have in the past.

Am I correct?

Mr. **Stockman**. That is correct.

Senator **Gorton**. So in order to get to those, that growth rate, that decline in unemployment, we are going to have to take the bull by the horns, we are going to have to start doing it this year.

Mr. **Stockman**. That is correct. The 1985 budget is determined by the economy of 1984. We think the assumptions for 1984 are realistic. They are in the middle of the field, where all private forecasters are, regardless of what they expect to happen or not happen on the deficit.

But for the years beyond fiscal year 1985, we have very clearly stated that much more needs to be done, that deficits that remain at $180 billion or more for sustained periods of time, are not acceptable, and that we will be back with additional recommendations next year.

So the whole economic path, out through 1989, in this budget is dependent on a down payment this year, so that the 1985 deficit is $180 billion or less, and a major improvement next year and the succeeding years, so that by 1988 the deficit would be under 2 percent of GNP or, in dollar terms, at least under $100 billion.

DEFICIT REDUCTIONS

Senator GORTON. The second question. This budget which you have submitted to us, does propose deficit reductions, however, they are arrived at, more than $100 billion, I believe approximately $106 billion over the next 3 years, against the administration's current service estimate.

Now, does that mean that the President's offer of a $100 billion deficit reduction over 3 years is simply a play on words? Does that mean that he really has not offered us anything, other than redistributing the misery, which is included in this budget, or does it mean that what we are working toward, and what he has proposed is $100 billion in lower budget deficits over the next 3 years, in addition to what is proposed in this budget?

Mr. STOCKMAN. Well, if you could do in addition to what is proposed in this budget, that would be so much the better. But I think what we had in mind was a hybrid. Some of the savings in this budget, frankly, your committee will not count. $30 billion of it is the difference between our old Defense path and what we are recommending this year. CBO and this committee use a different baseline.

But as for the other measures, we think that within the $73 billion, $33 billion on loopholes and another $40 billion in various types of moderate domestic cuts, that there ought to be things to choose from, in the sense of a menu, that the congressional side could agree to. And there will probably be other things that are not in here, not assumed in these numbers, that the congressional side would bring to the table in the tax loophole area and in the Defense area that we would agree to. The sum of those two components would be $100 billion and, hopefully, it would take us below the numbers for the deficit that you see in this budget.

Senator GORTON. So it is your hope and your intention that we should do better than the figures which are contained in this budget?

Mr. STOCKMAN. In the aggregate sense, that would be our desire.

Senator GORTON. Thank you, Madam Chairman.

Senator KASSEBAUM. Senator Chiles?

NEW SAVINGS TOTAL $68 BILLION

Senator CHILES. Just to follow up on that for 1 minute, if I can. What you are really telling us now is that you are not talking about $100 billion of new savings. You are talking about $68 billion. That distracts the baseline.

Now, you all come back each year and you put your request on Defense in and somehow call that your baseline.

Mr. STOCKMAN. That is right. We have almost the same conventions and accounting methods for everything else regarding the current services baseline as CBO. But there is not any agreement among any of the experts or technicians on the proper Defense baseline, so we used last year's budget.

Senator CHILES. But you do not use any other baseline figures. What were your requests on those other items? It is only on Defense that you change, right?

Mr. STOCKMAN. Well, CBO uses your policy. So in a sense, your budget resolution from last year——

Senator CHILES. We have argued this many times so maybe we do not need to go into it.

Mr. STOCKMAN. I do not think we need to. It is just accounting.

Senator CHILES. But the new thing to me is that really you are talking about a $68 billion proposal. If you are already counting $32 billion savings, that is the difference.

Mr. STOCKMAN. Yes, I think as you would count it you would find $68 billion over 1985, 1986, and 1987; 3 years of net policy changes in this budget.

FIRST YEAR SAVINGS OF $14 BILLION

Senator CHILES. Well, then, how much would you count under the $68 billion figure, how much would you be counting the first year under your figures, $68 billion?

Mr. STOCKMAN. The number for the first year would be about $14 billion in our budget.

And the number for the second year is about $26 billion and the number for the third year is about $33 billion.

Senator CHILES. And that would make up the $68 billion under these?

Mr. STOCKMAN. Yes.

Senator CHILES. So we are really only talking a change of $14 billion under the first year.

Do you think that is sufficient to give us any kind of——

Mr. STOCKMAN. It is not enough——

Senator CHILES. Staving off disaster that we all know is imminent for the deficits that we have? Do you think $14 billion is going to turn that around?

Mr. STOCKMAN. No, the point is that if you could come up with measures that would generate $14 billion in deficit reduction in 1985, they ~~would~~ generate a lot more the third year out, just in the nature of things. It takes time to build up savings either with a tax loophole or a spending change. So if we could do $14 billion, or hopefully $20 billion in 1985, we would really have put some kind of containment on the deficit for the out years. It is not going to be enough, but at least it stabilizes the situation. And that is basically what I have described in my testimony.

DEFENSE REQUEST

Senator CHILES. Well, if you are counting the $32 billion and—this is the first time I realized that you were in Defense—is that the Defense that is on the table?

Mr. STOCKMAN. No, I think it was very clear that the Defense on the table was the distance between you and us, ihat distance being $15 or $16 billion. That request is $305 billion. Your current position, which I trust you would stick with, is $289 billion in budget authority.

Senator CHILES. Well, it sounds like my answer to the question is that the Defense that is on the table is the $32 billion that you have added on.

Mr. STOCKMAN. Let me make one correction for the record.

I gather that the number of sharp pencils behind us have been adding things up and your number of $68 billion was not correct.

The number for non-DOD savings in the budget for those 3 years is about $73 billion. There is about $105 or $106 billion if you count the $32 billion for Defense. You do not want to count that.

So the sum of the revenue changes is $33 billion over 3 years, and the sum of the non-Defense outlay savings including debt service is $40 billion. That is a total of $73 billion.

MINIMUM SIZE OF GOVERNMENT

Senator **Chiles**. In your interview with Fortune magazine your position was described as follows: The minimum size of Government achievable appears to be 22 to 23 percent of GNP.

In view of the fact that revenues under current law are projected to be no greater than 19 percent of GNP, how do we reduce the size of our deficits; what do we do between the 19 percent and what you say is achievable? Of course, we are considerably higher than that now where we find ourselves approximately 25 percent. How do we close the gap?

Mr. **Stockman**. Well, I think what I was clearly suggesting in that article was that in the context of the kind of politics and legislative attitudes that we have had clearly apparent for a couple of years, I see no way that you could get below 22 percent or 23 percent of GNP. But if you wanted to do what was the right thing, you could get below 22 or 23 percent of GNP. In part 3 of the budget, we have laid out how you could get spending down to 20 or 21 percent of GNP.

BUDGET BELOW 22 PERCENT OF GNP NOT PROPOSED

Senator **Chiles**. Well, in addition to the politics that prevails around here, you have not proposed a budget that gets below 22 or 23 percent, or even gets to 22 percent; have you?

Mr. **Stockman**. Well, in the last year I think it was in the 23 to 24 percent range.

No, we have not proposed that here. The observation that I made is that we leave things in place. We do not ask anyone to do any more. For instance, ask the aviation industry to pay the full cost of the air traffic control system operations, go along with another farm program that is more or less like the last one that we had, do not do anything more significant on medicare than the kind of proposals being talked about now. Then, under those circumstances, you could not get it below 22 or 23 percent of GNP.

But if we are willing to bite some very tough bullets and look at these things in more than just the status quo way of the last year and a half, I believe you could get lower than that without depriving any particular group or region or sector of our country of things that they are entitled to.

Senator **Chiles**. But I gather from reading the article that you did not feel that you could go lower without causing too much disruption. But the other statement that you made was based on your assessment of——

Mr. **Stockman**. Of the politics.

CLOSE GAP BETWEEN 19 AND 22 PERCENT

Senator CHILES. Of the politics and what is happening. And after 3 years experience as being Budget Director you did not see it below 22 or 23 percent. So given that scenario, and I take it that was your judgment, how do we close the gap between the 19 percent and the 22 percent?

Mr. STOCKMAN. Well, I do not think that is a question we can properly debate today. We are not in this down payment negotiations going to come close to that. But that is an important start.

So let us work on the practical things that bear no relationship whatever to that long-run question. Next year we are either going to have to come forward with a way of coming below 22 percent or with the means of financing, to invent a new word, that will be needed to live with that over time. But I do not think there is any point in solving the entire equation on paper or in words here today.

Senator CHILES. Well, that is to say that because it is an election year, we are not going to talk about what we will do beyond this. I worry now that we are talking about only $14 billion in savings the first year. If we are not willing to share with the American people, and hear some things that we are going to have to do next year, or that this becomes a part of the so-called summit I wonder whether the $14 billion is going to give us any kind of a safety valve.

Mr. STOCKMAN. Well, I would say it would be desirable to do more, but when you know enough about this budget that when you sit down with a pencil and you try to add together things that will produce more than that, you are offering a temptation to an awful lot of people in the system to go out and demagog. Not you; I have never heard you do that or many other members of this Committee, but that does not bind or control others in various capacities in the House and Senate or campaigns, even on our team, that might try to do that.

So what I am saying here is that recognizing that everybody here is loose, running for reelection, what can we get done without having the whole thing blow up in demagoguery? And I think you are in the range of $14 to $20 billion when you recognize those realities that will not go away.

NEW REVENUES OR RAISE TAXES

Senator CHILES. If we are going to deal with the greater problem that we have and if we recognize that 22 or 23 is the most that we are going to get down to spending, and I happen to agree with that, I think we will be very fortunate. And if we can get it down to 22½ percent or something, because that means we have to come down a good ways, then I think we still have way too big a gap if we are talking about the difference between 19 and 23. That just tells me that we have to talk about new revenues or we have to talk about raising taxes. Everybody likes to talk about loophole closings and revenues and not talk about raising taxes. But you are going to have to do something if you are going to come to a balance. I see no reason why we should wait until after the election to say that. It seems like to me that if the American people knew that we were ready to close it, you know, and I think we would be able to have the time we need to get the job done. And I do not know how much of it we are going to be able to do now, but I think you have to be candid with them about what is going to happen.

I do not notice that you are ready to respond to that.

Mr. STOCKMAN. Well, I am more switching than reversing, to use your earlier characterization.

IMMIGRATION BILL UNACCEPTABLE

Senator CHILES. In a recent memo to Cabinet officials, you describe the immigration bill as unacceptable, citing budgetary concerns.

You are aware that aliens legalized under the legislation would not be eligible for Federal assistance for at least 3 years. Therefore the number of legalized persons is as high as your estimate, which I believe is rather high. We would have 3 years to address the public assistance issue.

I understand that your chief concern regarding the immigration legislation is the cost or benefits for those who are eligible for amnesty. I think that is correct.

We find ourselves in this situation, Mr. Stockman. The House including the leadership of the House, say that there is no reason they should bring up the bill because the President might veto it. And then there are loud remarks that come from others that say, no, the President is in support of this bill, he is not going to veto it. And then your comments come on that the bill is unacceptable.

So it certainly adds credence to the statement that has been made by the House leadership that the bill is in danger of veto. I happen to be one of those people that strongly support the bill. I think that we have to do something, and I could tell you the people in my State feel that way too. Maybe that is why I feel so strongly about it. We have had some of the influx from an open door policy and we are only looking at the tip of the iceberg with what could happen from Central America and from the Caribbean bringing hundreds of thousands of other people to our shores.

Have you estimated how much it is going to cost or what the cost is of doing nothing? How can we move this off the dime. Who speaks for the administration? Is the administration a supporter of this bill, Simpson-Mazzoli, how do we get this issue moved?

Mr. STOCKMAN. Senator, let me clarify the best I can. I think we made very clear all the way through when the bill started over here, and you were one of the strong supporters, that we wanted legislation, we wanted employer sanctions. We made clear that it was an urgent problem, and that if a more generous degree of legalization than we had in mind was necessary to get the sanctions, that is something that we could abide with.

We have also said all the way through that if the bill is loaded up with the kind of financial provisions and State and local financing provisions that are in the House bill, it would be unacceptable. The Attorney General said that a number of times, and it was in letters to both the House and Senate Committees.

I do not think our position has changed all the way through in that basic regard. We are strongly for the policy. We want a bill, but it should not be an excuse to load on a whole variety of open-ended programs for education, aid and so forth that are contained in the House bill. The Senate does not have that. The Senate has a block grant. It is the intention of Senator Simpson and others that that be a limited form of assistance to States, and we have said that we could live with that. And if everyone understands that that is where we are, it does not seem to me that there should be any excuse for the House not moving forward with an acceptable bill.

Senator **Kassebaum**. Senator Grassley.

GRACE COMMISSION REPORT ON DEFENSE STRONGLY ENDORSED

Senator **Grassley**. Thank you, Senator Kassebaum.

I want to visit a little bit about the projection from which the budget faced, but before I do that, I would like to carry on a little bit where Senator Kassebaum left off and just make a statement with regard to what the administration might do on defense in the Grace Commission report. I would hope the very least since the President has so strongly endorsed the provisions of the Grace Commission, that everything that could be done within the Defense Department, whether it be on the personnel side or whether it be on the procurement side, that could be done without congressional authorization be done. And I guess I would expect that that would be done and, of course, I would express a willingness because of my interest in the Defense Department to work with the President and anybody else on those things that take legislation to accomplish.

IDEAL PATH FOR ECONOMY

Now, I would like to just touch a little bit on your economic assumptions that are in the budget that we received 2 days ago. We have 91-day T bills falling to 5 percent by 1989, real growth averaging 4 percent over the 7-year period of time beginning in 1983 without a downturn, and deficits falling to $120 billion by 1989, if the President's budget is enacted. Just like a couple of other people have said, they would like a candid answer from you, I would like to know how confident you are in those projections.

Mr. **Stockman**. Well, I think I indicated earlier that that is an ideal path for the economy, it is one that could be achieved in the sense that it does not require historic miracles. We have had that kind of growth for 7 years before. We can have that kind of inflation, we had it persistently prior to the midsixties. If you have low inflation and a stable level of growth, those interest rates reflect a trend of real rates of interest that is consistent with the past.

Now, the question is: can we implement the fiscal and monetary policies that would be conducive or supportive of the economy moving along that path? This budget does not have for the outyears the fiscal policies that will be needed to keep us on this path, and we deliberately said that, and we are going to have to do a lot more next year.

Senator **Grassley**. Then in the outyears, and they are really goals and not projections.

Mr. **Stockman**. That is right.

Senator **Grassley**. They are goals?

Mr. **Stockman**. They are objectives.

HISTORICAL ANALYSIS OF ADMINISTRATION'S PROJECTIONS

Senator GRASSLEY. OK.

Well, as I look to the future, of course, I have no idea, I suppose, as to what to expect, especially when we consider the mounting debt that we have, and I feel from today's discussions that members of the committee feel about the same anxiety I do about the future. So I just wondered if in the way of your sending to the Hill, to me or to the committee, or to both, just a little bit of information so that we can feel some confidence whether these be goals or projections that you have, assuming certain things as to what to expect in the future.

I wonder if you could submit for the committee an analysis of the history of the administration's projections and how close those projections came to reality. And I am referring to what would be similar or more information than is on page 2–15. You lay out there a comparison of economic assumptions for last year's 5-year projections, and also for this year. So I wonder if you could supply this committee with all the 5-year projections of the administration that would be for the previous years, and then on into the 5 years and compare them to what actually occurred. And as far as I am concerned, if you would like to go back to the previous administrations, that is all right with me, but I would at least like to have it for this administration. I would like to see the analysis for deficits, outlays, revenues, tax expenditures, GNP, interest rates, inflation, unemployment, and outlays as a percentage of GNP and, of course, anything else that you think would be valuable. But I would like to have it so I can look at what our track record has been and then find out whether there is a justification for the optimism that is projected here.

Mr. STOCKMAN. Well, I would be happy to do that, Senator.

[The following was subsequently supplied for the record:]

PUBLISHED PROJECTIONS OF THE BUDGET OUTLOOK
(fiscal years; in billions of dollars)

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
Receipts													
January 1975 (Ford)...	278.8	297.5	362.5	405.8	452.3	501.7							
January 1976 (Ford)...		297.5	351.3	406.7	465.3	523.1	585.4						
January 1977 (Ford)...			354.0	393.0	454.4	510.0	553.1	587.3					
January 1978 (Carter).				400.4	439.6	505.4	583.5	657.6	726.1				
January 1979 (Carter).					456.0	502.6	575.8	652.6	718.3	780.2			
January 1980 (Carter).						523.9	600.0	691.1	798.8	920.5	1,061.2		
January 1981 (Carter).							607.5	711.8	809.2	922.3	1,052.6	1,188.5	
March 1981 (Reagan)...							600.3	650.3	709.1	770.7	849.9	940.2	
February 1982 (Reagan)								626.8	666.1	723.0	796.6	861.0	925.7
January 1983 (Reagan).									597.5	659.7	724.3	841.9	916.3
February 1984 (Reagan)										670.1	745.1	814.9	887.8
Actual................	279.1	298.1	355.6	399.6	463.3	517.1	599.3	617.8	600.6				
Outlays													
January 1975 (Ford)...	313.4	349.4	393.1	425.4	451.9	476.7							
January 1976 (Ford)...		373.5	394.2	429.5	455.7	482.5	509.9						
January 1977 (Ford)...			411.2	440.0	466.0	496.6	527.0	558.7					
January 1978 (Carter).				462.2	500.2	542.9	575.4	612.4	650.0				
January 1979 (Carter).					493.4	531.6	577.0	614.9	645.6	673.7			
January 1980 (Carter).						563.6	615.8	686.3	774.3	838.9	902.6		
January 1981 (Carter).							662.7	739.3	817.3	890.3	967.9	1,050.3	
March 1981 (Reagan)...							655.2	695.3	732.0	770.2	844.0	912.0	
February 1982 (Reagan)								725.3	757.6	805.9	868.5	927.0	978.9
January 1983 (Reagan).									805.2	848.5	918.5	989.6	1,058.4
February 1984 (Reagan)										853.8	925.5	992.1	1,068.3
Actual................	324.2	364.5	400.4	448.4	491.0	576.7	657.2	728.4	796.0				
Surplus or Deficit (-)													
January 1975 (Ford)...	-34.7	-51.9	-30.6	-19.6	0.4	25.0							
January 1976 (Ford)...		-76.0	-43.0	-22.8	9.6	40.6	75.5						
January 1977 (Ford)...			-57.2	-47.0	-11.6	13.4	26.1	28.6					
January 1978 (Carter).				-61.8	-60.6	-37.5	8.6	45.2	76.2				
January 1979 (Carter).					-37.4	-29.0	-1.2	37.8	72.7	106.5			
January 1980 (Carter).						-39.9	-15.9	4.8	24.5	81.6	158.6		
January 1981 (Carter).							-55.3	-27.5	-8.0	32.0	84.7	138.2	
March 1981 (Reagan)...							-54.9	-45.0	-22.8	0.5	5.8	28.2	
February 1982 (Reagan)								-98.6	-91.5	-82.9	-71.9	-66.0	-53.2
January 1983 (Reagan).									-207.7	-188.8	-194.2	-147.7	-142.1
February 1984 (Reagan)										-183.7	-180.4	-177.1	-180.5
Actual................	-45.2	-66.4	-44.9	-48.8	-27.7	-59.6	-57.9	-110.6	-195.4				

PUBLISHED PROJECTIONS OF THE BUDGET OUTLOOK (CONT.)
(fiscal years; in billions of dollars)

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
Outlays as % of GNP													
January 1975 (Ford)...	21.9	21.9											
January 1976 (Ford)...		23.4	21.5										
January 1977 (Ford)...			22.5	21.6	20.5								
January 1978 (Carter).				22.6	22.0								
January 1979 (Carter).					21.6	21.2	21.0	20.3					
January 1980 (Carter).						22.4	22.3	22.1	22.0				
January 1981 (Carter).							23.3	23.0	22.6	22.0	21.5	21.2	
March 1981 (Reagan)...							23.0	21.8	20.3	19.3	19.2	19.0	
February 1982 (Reagan)								23.5	22.1	21.3	20.9		
January 1983 (Reagan).									25.2	24.3	24.1	23.9	
February 1984 (Reagan)										24.0	23.9	23.4	23.3
Actual................	21.9	22.2	21.5	21.4	20.8	22.4	22.9	23.8	24.7				

PUBLISHED PROJECTIONS OF THE ECONOMIC OUTLOOK
(calendar years)

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
Nominal GNP (% change; year/year)													
January 1975 (Ford)...	7.2	12.6	12.4	12.0	10.8	10.9							
January 1976 (Ford)...		12.4	12.2	12.4	11.9	10.9	9.1						
January 1977 (Ford)...			11.0	11.3	11.6	10.5	7.9	6.4					
January 1978 (Carter).				11.0	11.2	10.9	10.5	9.6	8.5				
January 1979 (Carter).					11.3	9.5	10.1	9.4	7.9	6.3			
January 1980 (Carter).						8.3	10.7	12.8	12.9	12.0	11.0		
January 1981 (Carter).							11.4	13.1	12.3	11.8	11.0	10.2	
March 1981 (Reagan)...							11.1	12.8	12.4	10.8	9.8	9.3	
February 1982 (Reagan)								9.1	11.5	10.2	9.7	9.2	9.0
January 1983 (Reagan).									6.7	9.3	9.1	8.8	8.7
February 1984 (Reagan)										10.1	9.1	8.7	8.4
Actual................	9.0	10.9	11.6	12.8	11.7	8.9	12.3	4.0	7.7				
Real GNP (% change; year/year)													
January 1975 (Ford)...	-3.3	4.8	5.6	6.5	6.5	6.5							
January 1976 (Ford)...		6.2	5.7	5.9	6.5	6.5	4.9						
January 1977 (Ford)...			5.2	5.1	5.9	5.5	3.9	3.5					
January 1978 (Carter).				4.7	4.8	4.8	5.0	4.7	4.2				
January 1979 (Carter).					3.3	2.5	4.2	4.7	4.4	3.4			
January 1980 (Carter).						-0.6	1.7	4.3	5.0	4.9	4.7		
January 1981 (Carter).							0.9	3.5	3.5	3.7	3.7	3.7	
March 1981 (Reagan)...							1.1	4.2	5.0	4.5	4.2	4.2	
February 1982 (Reagan)								0.2	5.2	5.0	4.7	4.4	4.3
January 1983 (Reagan).									1.4	3.9	4.0	4.0	4.0
February 1984 (Reagan)										5.3	4.1	4.0	4.0
Actual................	-1.1	5.4	5.5	5.0	2.8	-0.3	2.6	-1.9	3.3				
GNP Deflator (% change; year/year)													
January 1975 (Ford)...	10.8	7.5	6.5	5.1	4.1	4.0							
January 1976 (Ford)...		5.9	6.2	6.1	5.0	4.2	4.0						
January 1977 (Ford)...			5.6	5.9	5.4	4.7	3.9	2.8					
January 1978 (Carter).				6.1	6.2	5.7	5.2	4.7	4.2				
January 1979 (Carter).					7.7	6.9	5.7	4.5	3.4	2.8			
January 1980 (Carter).						8.9	8.9	8.2	7.4	6.8	6.1		
January 1981 (Carter).							10.5	9.3	3.5	7.8	7.0	6.3	
March 1981 (Reagan)...							9.9	8.3	7.0	6.0	5.4	4.9	
February 1982 (Reagan)								7.9	6.0	5.0	4.7	4.6	4.5
January 1983 (Reagan).									5.2	5.2	4.3	4.6	4.5
February										[illegible]	[illegible]	[illegible]	[illegible]
Actual...													

PUBLISHED PROJECTIONS OF THE ECONOMIC OUTLOOK (CONT.)
(calendar years)

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
Unemployment Rate (%, civilian labor force; year average)													
January 1975 (Ford)...	8.1	7.9	7.5	6.9	6.2	5.5							
January 1976 (Ford)...		7.7	6.9	6.4	5.8	5.2	4.9						
January 1977 (Ford)...			7.3	6.6	5.7	4.9	4.9	4.7					
January 1978 (Carter).				6.3	5.9	5.4	5.0	4.5	4.1				
January 1979 (Carter).					6.0	6.2	5.7	4.9	4.2	4.0			
January 1980 (Carter).						7.0	7.4	6.8	5.9	5.1	4.3		
January 1981 (Carter).							7.8	7.5	7.1	6.7	6.3	6.0	
March 1981 (Reagan)...							7.8	7.2	6.6	6.4	6.0	5.6	
February 1982 (Reagan)								8.9	7.9	7.1	6.4	5.9	5.3
January 1983 (Reagan).									10.9	10.0	9.0	8.2	7.4
February 1984 (Reagan)										7.9	7.7	7.5	6.9
Actual................	8.5	7.7	7.1	6.1	5.8	7.1	7.6	9.7	9.6				
91-day T-bill rate (%, bank discount basis)													
January 1975 (Ford)...	6.4	6.4	6.4	6.0	5.0	5.0							
January 1976 (Ford)...		5.5	5.5	5.5	5.5	5.0	5.0						
January 1977 (Ford)...			4.4	4.4	4.4	4.4	4.4	4.4					
January 1978 (Carter).				6.1	6.1	6.1	6.1	5.8	5.3				
January 1979 (Carter).					8.8	7.6	6.6	5.4	4.4	3.7			
January 1980 (Carter).						10.5	9.0	8.4	7.7	7.0	6.3		
January 1981 (Carter).							13.0	11.0	9.4	8.5	7.7	6.8	
March 1981 (Reagan)...							11.1	8.9	7.8	7.0	6.0	5.6	
February 1982 (Reagan)								11.7	10.5	9.5	8.5	7.0	5.5
January 1983 (Reagan).									9.0	7.9	7.4	6.8	6.5
February 1984 (Reagan)										10.3	9.2	8.6	7.2
Actual................	5.8	5.0	5.3	7.2	10.0	11.5	14.1	13.0	11.1				

Senator **Grassley**. OK.

Thank you, Madam Chairman. That is all I have.

Senator **Kassebaum**. Senator Biden.

TAX POLICY

Senator **Biden**. Thank you very much. I will be brief, Mr. Stockman.

Obviously tax policy sets off the topic of tax increases or no tax increases. As the time goes on, as we develop the details of the budget, I will get into a series of questions I have. I would like to ask if I could submit three of them to you without taking your time now and they relate to projections, et cetera.[1] Without getting into that now, I would like to, in line with my opening comment, that it is time to declare a truce, make a suggestion, and I do not need you to respond now but maybe think about.

FUNDAMENTAL OVERALL TAXING SYSTEM

The President, in his state of the Union message, spoke to the question of tax policy beyond the question of tax initiatives that we have attempted to discuss for three years up here, whether you reduce taxes, increase taxes, change all of the loopholes, as the public refers to them. Several of we Democrats, and I am sure some Republicans, have tax policy changes up here, and I only speak to the proposal that I am most deeply involved in and working on the most. Senator Bradley and I on the Senate side have a proposal, Bradley being the chief sponsor and author of it, but I have worked very closely with him on it for a couple of years. It is a fundamental overhaul taxing system.

I have heard rumblings that you all in the administration are thinking about, not the Bradley-Biden or Bradley-Gephardt approach to the thing, but about different kinds of flat taxes, fundamental changes in the tax structure, the tax code.

I respectfully suggest that is one of the bases upon which we may be able to get a handle and some consensus here this year. We may not be able to make a judgment that we are going to fundamentally alter the deficits, although I hope we can this year. But in line with your analogy, your characterization of what on the House and Senate funding for the carrier fleet, what that meant, it ties us in for years. What I meant before about the future slipping from our grasp, that is an example of a decision made that no rational woman or man can now turn around automatically, because you have just committed yourself for a long time. The same way the B-1 bomber now. I think somewhere along the line, not only on defense but on taxes, we have to, in a bipartisan way, say, all right, we are prepared to make major changes. We are not wrong in what we did at the time, but in hindsight we can no longer afford to continue what we set in motion.

With regard to the tax policy side of that, I took the President to be sincere at the state of the Union when he said—when he made reference to major changes in tax policies.

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[1] See p. 657.

I would like to suggest that, and it need not be at a presidential level, maybe just Senator Bradley and I could just start with you or anyone you think, seek your advice, sit down and begin to talk about whether or not the way to deal with revenues, present and future, is to begin to agree on the outline of some changes in tax policy. If we can. And very—we are both politicians, I would respectfully suggest that may be a way out. That may be a way out of the approach that relates to whether or not we are going to increase taxes or decrease taxes or favor the wealthy or favor the poor and all these things which are the polemic arguments that we get into, not because we want to, but because there is some substance to both arguments.

TAX OVERHAUL

So my first question is whether or not you think it is worthwhile to even attempt to discuss in the next little bit, the next several months, this issue of long-range tax policy, I will call it tax overhaul, that I thought the President was talking about?

Do you think that is worthwhile and, if so, how would you move forward with something like that?

Mr. **Stockman**. Well, I think it is very worthwhile, and it is consistent with what we have stated in the budget regarding the goal of tax reform and simplification for the future, and consistent with what the President said in the state of the Union message.

We may be reaching the point where whatever your philosophical view on the distribution of the tax burden and so forth, that people have come to the conclusion that the current tax code is reaching a critical mass of complexity, inequity, and even arbitrariness, in the way it treats differently-situated incomes, entities and so forth, that something rather major by way of overhaul needs to be done.

So I think everybody is coming to that conclusion, it does provide an opportunity to reshuffle the deck, obscure the baseline, and what comes out of that might be easier to manage, than if we began with the known baseline.

I would suggest that small changes from the well known baseline are more difficult than larger changes from an ill-understood one, and so there may be some——

Senator **Biden**. I was not being facetious, and I do not think you are, either. The fact of the matter is, I think that we would all be better prepared to be able to go to our respective constituencies, including the President, whose constituency is the whole country, if in fact there was some reason to be able to assure the people that they were getting a different shuffle in the deck, without reshuffling the income structure in this country.

I feel very strongly about our tax proposal. But the fact of the matter is, and by the way, very bluntly, I am not sure that Bradley and I can convince our colleagues in the Senate. But I am not sure the institutional centers are the place from which to begin some of these discussions.

BUDGET REVISIONS IN LIGHT OF GRACE COMMISSION REPORT

The second point, the Grace Commission, and I know my time is running out, the Grace Commission. That is a very—potentially a convenient political departure point for the President, potentially, and for those of us running for office, and all of us in Congress are always doing that, most of us are.

I would hope that—let me ask the question without I hope.

Can we—in light of the President's strong endorsement of the commission, can we expect that we are going to see revisions in the budget proposal submitted by you, which obviously had to be compiled and submitted before the report was finally—the Grace Commission report was finally in, can we expect to see any significant revisions in your budget proposal, in light of the Grace Commission report?

Mr. STOCKMAN. I would think so.

Senator BIDEN. You would think so?

Mr. STOCKMAN. There are some 2,400 line-item recommendations in there. Some of them are very simple, many of them we are doing, others involve complicated questions of policy that deserve to be looked at. So we are going to go through a year-long process of sifting and wading through it. It does have a certain credibility that transcends politics, administration politics, your politics, and hopefully would become the basis for going after things in the future that we are stalemated on now.

Senator BIDEN. Well, with your permission, and out of the glare of anybody's lights or microphones, I have not even discussed it with Senator Bradley, but you may—I hope when you get a phone call from me, you will be at least willing to sit down.

I know you are not the tax man in the administration, but it is a place from which to start, since it is part of the overall budget, at least let two of the Members of the Senate, who do not even represent—I cannot say that we speak for the Democrats, we do not, but come and sit with you for a few minutes, and just bounce some of these ideas off of you.

Mr. STOCKMAN. Fine.

Senator BIDEN. Thank you.

Senator KASSEBAUM. Thank you, Mr. Stockman, for a masterful presentation.

Senator Domenici has a couple of questions that he would like to present for the record.[1]

Senator RIEGLE. Madam Chairman——

Senator KASSEBAUM. I thought you had asked——

Senator RIEGLE. I have, I have been waiting here for a second chance to do that.

Senator KASSEBAUM. All right.

Senator RIEGLE. I am interested in what everybody else has to say.

Mr. STOCKMAN. Senator, if I could submit the answers for the record, maybe we could do it that way.

Senator KASSEBAUM. He has to leave for the White House, for a meeting with the President.

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[1] See p. 657.

Could you do one brief one?

MAJOR ATTACK ON MIDDLE CLASS PLANNED

Senator RIEGLE. I will be very brief. We will not go 5 minutes, but I do want to pose one other thing here, it is very important, and if you want to submit it for the record, that may be the best we can do.

But it seems to me that the big news in the budget presentation today is not the size of the deficits, because we knew that yesterday, but what is in the presentation, starting on page 15 of your prepared statment,[1] and that is the fact that you are obviously planning a major attack on the middle class, but it is not going to come until after the election.

I just want to put in the record a couple of your own sentences, starting on page 15, where you lay out seven targets for the future, not now, in this political environment, but starting next year, which you say have to be firmly curtailed, which must be subjected to fundamental scrutiny and revision next year, this is what they are: Farm price supports, so the farmers are for some reason listed first as a target group for you, and then you go on next to student aid, and higher education, still looking for defense, that is not in this list, as you know.

Mr. STOCKMAN. It is.

Senator RIEGLE. It is buried. It is buried and it is certainly not there as a major category. It is almost a footnote.

The third item, "Veterans health care systems." The fourth item, "Medical entitlements," which is a euphemism essentially for medicare. And you proposed last year major cuts in medicare benefits that would have hurt people, you have withdrawn those this year obviously because of the politics. But I think you are making it very clear, although in softball language, that you are coming back next year to get those and more.

Then you go on to Federal military and Government pensions and then you go down into other kinds of services, essential sort of baseline services like rural electric and telephone cooperatives, mass transit systems, the Coast Guard, et cetera. And Defense, to say that that is put on anything like an equal footing as separate category or a category of equal size, that just is not the way this is presented, it is not the way it reads.

But in the interest of honesty, I think it is important that this really be laid out, I mean laid out clearly. The President, I think, had an obligation to say it the other night in the state of the Union message. He said none of this. He did not put anybody on notice that they were on the hit list, that they were not going to be on the hit list until next year right after the election.

Mr. STOCKMAN. Senator, if I could respond.

Senator RIEGLE. You can in just a second, as soon as I finish.

The fact of the matter is that it seems to me that what you are doing is enumerating the prime targets, and you can read the language if that is necessary. But you enumerate the prime targets and I think it is important that people have a way of knowing that they are the targets and that they have a way of knowing that now so that we can get this debate going now and not later when it will be too late to try to head this thing off.

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[1] See p. 40.

FARM SUBSIDIES

Mr. **Stockman**. Well, Senator, if I could respond. I think we are trying to make a constructive effort to suggest where we are going to have to look hard in the future on the spending side, which is my jurisdiction; the Tax Code side is not. We have been working the areas that I have enumerated on for 3 years. There is nothing new about farm subsidies. There is not a member of this committee who believes that the 1981 Farm Act was a good one. And when I heard the front-running candidate of your party suggest that he could cut $15 billion in farm subsidies as part of his deficit reduction plan, I figure it would be safe to put it in there. So that is why it is in there.

MEDICARE AND MEDICAID

Now, the next area, medicare and medicaid. There is not one member of this committee who has not wrung his hands about a program that has been growing in real terms at 8 or 9 percent per year for 20 years due to the cost growth of health care in the private sector, and not the fault of the beneficiary. I am not suggesting that, but when I heard the leading Presidential candidate of your party suggest that he could cut medical entitlements, the word I use, by $15 billion a year by 1988, I thought it would be safe to put that one in there as well. So I did.

DEFENSE

Then I listened all day at the attacks on the rate at which the Defense budget has gone up and the share for readiness has declined and procurement has gone up. So I put a whole section in there on how we are spending $200 billion for procurement, much of which is defense that would cost less if we could implement some of these reforms the Congress has resisted like multiyear contracting. So I put that one in there because I know that is what you would be recommending here today.

STUDENT AID

As for student aid, I put it in there because I testified for 3 years in a row why I think the student aid budget is too big and I did not think it would be a surprise or news to anybody.

Now, somehow by putting together in a way that was meant to be constructive, a general classification of the major budget areas that had to be looked at, that accord with much of what the members of this committee are saying, that parallel precisely what the leading candidate of your party has suggested that he will do in his $100 billion deficit reduction plan, you are now going to try to say this is a hit list. Well, it is not. This is a discussion of the kind of things that we are going to have to look at in the budget.

TARGET DATES OF CUTS

Senator RIEGLE. I am making a second point, I am also making the point that you are targeting these areas but you are targeting them not now——

Mr. STOCKMAN. Well, there are things in the budget, Senator, that cut everyone of these areas.

Senator RIEGLE. But you are, are you not, targeting these things for calendar year 1985?

Mr. STOCKMAN. No.

Senator RIEGLE. You are not targeting them this calendar year?

Mr. STOCKMAN. It is wrong. This budget proposes——

Senator RIEGLE. That is what you say here.

Mr. STOCKMAN. No, this budget proposes to cut target prices, freeze them. My long-term discussions suggest that the farm law is expiring in 1985 and we can have a better one for the next 5 years.

Senator RIEGLE. I am talking about the additional cuts. I am talking about the additional cuts that you start enumerating on page 15.

Mr. STOCKMAN. That is right.

Senator RIEGLE. You have several pages here on this, and I think it is good that they are in here, and I think that the critical part of the package is the fact that you enumerate these. The point, however, is that you are putting all of this off, these additional deep cuts, until next year. They come in 1985.

Mr. STOCKMAN. Well, now——

Senator RIEGLE. Calendar year 1985.

Mr. STOCKMAN. Well, let us just state two facts.

One, in some cases, you cannot do it until next year.

The farm bill expires next September, and the Congress will pass a new farm bill in 1985, and I am suggesting that that is the time not to make the mistake, by all accounts, we made when we passed the 1981 Farm Act. We have a 5-year bill coming at us, and let us do it right the next time.

Now, medicare, we are going to have to have a solvency plan, and it is clear that nobody is going to pass a plan to fix the system for 10 or 15 years in a couple of months before this election. So we are going to take that up next year and the year after.

It was in that vein and in that framework that this discussion was carried out.

Senator RIEGLE. Well, I do not dispute that. What I am saying is that this represents a targeting of the middle class that is different than we have seen before. It is carried even in a front page story on the Wall Street Journal today, as they have analyzed it, and they reached the same conclusions.

Mr. STOCKMAN. The last time you said that it was not fair because we had not cut the middle class, and we were coming down too hard on the lower income group.

MIDDLE CLASS SLIDING BACKWARDS

Senator RIEGLE. No, I beg your pardon. I think the middle class is the critical area, that is sort of giving us our major strength, over a long period of time, I am for increasing the size of the middle class. It is not increasing.

In fact, you yourself conceded earlier, if you take all the net tax changes, and I can show you the numbers in terms of what is happening to the middle class, let us take people just from $20,000 to $30,000 a year, over the last 3 years, you take all of the tax changes and the inflation, they are sliding backwards. They are not gaining. The folks that are gaining are at the high end of the scale. That leaves a decided debate on the poor, but the middle class is not making headway, and you just put them right at the top of your target list, but you have not done it for this year. You have done it for 1985, and I think that is something that they need to know now.

I thank you for coming today.

Senator **Kassebaum**. The hearing is concluded.

[Whereupon, at 12:45 p.m., the committee was adjourned, subject to the call of the Chair.]

VIEWS OF THE REAGAN ADMINISTRATION

FRIDAY, FEBRUARY 3, 1984

U.S. Senate,
Committee on the Budget,
Washington, D.C.

The committee met, pursuant to notice, at 9:30 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman) presiding.

Present: Senators Domenici, Kassebaum, Andrews, Symms, Grassley, Kasten, Quayle, Gorton, Chiles, Biden, Johnston, Sasser, Metzenbaum, Riegle, and Exon.

Staff present: Stephen Bell, staff director; and Gail Fosler, chief economist.

For the minority: Richard N. Brandon, staff director; and Garry Schinasi, senior economist for macroeconomics and fiscal policy.

Senator Kassebaum. Secretary Regan, it is a pleasure to welcome you. My apologies for being a bit late. I was visiting with some Kansas constituents who wanted to know how we were going to balance the budget, and I said, "Well, come with me, and we will find out."

But it is a pleasure to welcome you to the committee. As you know, Senator Domenici cannot be with you this morning because he is at the White House with the President, working on the legislative language to implement the recommendations of the Central American Commission.

Senator Domenici has a statement, which I will enter into the record. However, he makes several important points which I share, and I will be very brief.

[The prepared statement of Chairman Domenici follows:]

PREPARED STATEMENT OF CHAIRMAN DOMENICI

MR. SECRETARY, FIRST LET ME WELCOME YOU AND COMMEND YOU FOR YOUR PART IN DEVELOPING THE PRESIDENT'S FISCAL YEAR 1985 BUDGET REQUEST. THIS YEAR'S TAX PROPOSALS ARE VERY MUCH IN KEEPING WITH A POLICY THAT I AND MANY MEMBERS OF THIS COMMITTEE HAVE LONG ADVOCATED -- REFORMING AND SIMPLIFYING THE NATION'S TAX CODE TO ASSURE THAT EVERYONE PAYS HIS FAIR SHARE OF THE COST OF RUNNING THIS COUNTRY.

AS I INDICATED IN MY STATEMENT TO MR. STOCKMAN YESTERDAY, THE PRESIDENT AND THE CONGRESS SHARE RESPONSIBILITY FOR THE DRAMATIC IMPROVEMENT IN OUR NATION'S ECONOMY. AS A RESULT, WE HAVE THE LUXURY OF CONSIDERING THE NEXT STEPS IN OUR EFFORT TO BRING DOWN BUDGET DEFICITS IN AN ENVIRONMENT OF STRONG ECONOMIC STABILITY.

THIS OASIS WILL NOT LAST FOREVER. BUT THE SIGNS ARE CLEARLY GOOD THAT THE ECONOMY WILL CONTINUE VERY STRONG THROUGH OUT THIS YEAR AND WELL INTO NEXT.

THE JOB HAS NOT BEEN EASY. BOTH THE PRESIDENT AND THE CONGRESS HAVE MADE DIFFICULT POLITICAL DECISIONS. AND MANY MORE REMAIN TO BE MADE.

IN THAT REGARD, NEITHER THE ADMINISTRATION NOR THE CONGRESS IS OUT OF THE WOODS YET. INDEED, IN THIS ELECTION YEAR, THE NATURAL TENDENCY IS FOR THE WOODS TO THICKER AND THICKER. HOWEVER, THE PRESIDENT'S INITIATIVE IN HIS STATE OF THE UNION MESSAGE OFFERS A WAY OUT -- AND IT IS THE TASK OF THIS COMMITTEE TO WORK WITH YOU AND OTHER MEMBERS SO THIS ADMINISTRATION TO CONTINUE TO MAKE PROGRESS ON THE DEFICIT ISSUE.

THE PRESIDENT HAS PROPOSED $33.7 BILLION IN REVENUE INCREASES OVER THREE YEARS. HE HAS ENDORSED MANY OF THE REVENUE PROPOSAL CONTAINED IN THE 1983 HOUSE REVENUE BILL AND THE REVENUE PORTIONS OF THE SENATE RECONCILIATION BILL.

WE HAVE IMPORTANT SPENDING CUTS IN THESE BILLS, CUTS THAT HAVE ALREADY PASSED THE HOUSE AND, IN MY JUDGMENT WOULD READILY PASS THE SENATE. THE STUMBLING BLOCK IS TAXES. WE HAVE DESPARATELY NEEDED THE PRESIDENT'S SUPPORT FOR THESE TYPES OF TAX CHANGES. NOW WE HAVE IT.

THE PRESIDENT'S SUPPORT OF THESE BASIC TAX REFORM MEASURES BREAKS THE LEGISLATIVE LOG JAM. NOW, WE HAVE A LEGISLATIVE VEHICLE THAT WE CAN MOVE FORWARD. FRANKLY, MR. SECRETARY, I AM OPTIMISTIC THAT WE CAN PUT A PACKAGE TOGETHER AND MOVE FORWARD QUICKLY.

FINALLY, MR. SECRETARY, I WAS PARTICULARLY PLEASED TO SEE THE ADMINSTRATION'S SUPPORT FOR ONE SMALL ITEM THAT IS OF SPECIAL INTEREST TO ME -- THE TARGETED JOBS TAX CREDIT. I HAVE JOINED WITH SEVERAL OTHER SENATORS TO SPONSOR THIS LEGISLATION AND I AM DELIGHTED TO NOW HAVE THE ADMINISTRATION'S ACTIVE SUPPORT.

MR. SECRETARY, IT IS GOOD TO HAVE YOU HERE TODAY, AND WE LOOK FORWARD TO YOUR TESTIMONY.

OPENING STATEMENT OF SENATOR KASSEBAUM

Senator KASSEBAUM. You are to be commended, Mr. Secretary, for your role in developing the President's budget proposals. The President has proposed $33.7 billion in revenue increases, aimed at reforming the tax system to make it simpler and more equitable. Indeed, this is an approach which many members on this committee have strongly advocated for some time.

More importantly, Mr. Secretary, many of the proposals that the President supports are at this very moment contained in the House revenue bill and the revenue portions of the Senate reconciliation bill.

These bills contain important spending cuts, spending cuts which have already passed the House of Representatives and which in my judgment would readily pass the Senate. The stumbling block is taxes.

The point is simple. We have needed the President's support to move ahead. Now we have it. The President's support breaks the legislative logjam.

Frankly, Mr. Secretary, I am confident that we can move ahead quickly to put together a package, a package equal to or in excess of $100 billion over 3 years. For the first time in the past year, I am optimistic that we can really move ahead with actual legislation to reduce budget deficits. Clearly, $100 billion over 3 years does not solve our problem, but it keeps the process moving forward.

Mr. Secretary, it is good to have you here today, and we look forward to your testimony.

Senator Chiles, do you have an opening statement?

OPENING STATEMENT OF SENATOR CHILES

Senator CHILES. Yes, ma'am.

Mr. Secretary, we are glad to have you here this morning. I guess today, we are having both sides of the administration. I do not know whether you represent the Hatfields or the McCoys, but Mr. Feldstein will be here this afternoon, and we will get a chance to hear both sides. I am sure that both sides of the administration, though, just like the Congress, have the same eventual aim, and that is trying to cut the deficit.

I wonder whether we can do that, though, without budgetwide programs of adjustment in all areas, and including the revenues and defense.

LONG-RANGE ECONOMIC ASSUMPTIONS OVERLY OPTIMISTIC

I am concerned that the long-range economic assumptions in the budget seem to be overly optimistic. The 4-percent growth rate for each of the next succeeding years to 1989 is considerably higher than the conventional forecasters who are talking about 3.5 percent. Unemployment is expected to fall to 5.8 percent, but conventional wisdom seems to be that we could get it down to 6.5 percent by 1989. The T-bill rate of 5 percent in 1989 certainly comes as a surprise to most of the analysts, who expect it to be around 8 percent.

I do not see how we can accomplish this in the face of the deficits that we are looking at. And I will have to say that my doubts are even greater after looking over the economic report of the President, released yesterday. That report tells us that we can expect those deficits to be in the $200 billion range for the rest of the decade without legislative changes to reduce spending or raise revenues. I agree with that, except I do not think it should be an either/or; I think it has to include both.

That report is also skeptical of your Treasury bill rate projection of 5 percent by 1989. The way the report puts it, if there are not legislative changes to reduce outlays and increase receipts—and I am glad that they include both—the Treasury bill will remain at its current rate. That would make the deficit about $250 billion in 1989.

And yet, the budget that you bring to us does not tell us what those changes are going to be. That remains a mystery.

STRUCTURAL DEFICIT COULD BE $197 BILLION

And finally, the report notes that the structural deficit in 1989, the deficit that economic growth will not remove, could be $197 billion. The report observes, and I quote: "It would require an increase of 40 percent in the projected growth rate over the next 6 years to eliminate the budget deficit by the end of the decade without a change in the spending or tax rules." And yet, we are told over and over that recovery is going to take care of all this; it is steady, and we are going to grow our way out of it. I think you can understand my reason for skepticism when I find things like that in the President's economic report, and I am even skeptical about the 1985 deficit, that it will be $180 billion as you project.

I will tell you why. Last June, the Treasury Department issued a report which claimed the Nation's all-time high deficits would have no adverse impact on the economy. Then, last October, you told the U.S. Chamber of Commerce that you expected the fiscal 1985 deficit to be around $100 billion. I found that your position was based, first of all, on the assumption that the deficit was really $170 billion rather than $200 billion—at least, that is what my staff was told by Treasury officials. Next, spending underruns were supposed to save another $15 billion. And to tell you the truth, spending underruns are just about as common as whooping cranes or black panthers in the State of Florida.

And finally, another $20 billion in spending cuts were to bring the figure down to $120 billion, which was then just rounded off to $100 billion.

Now, I understand you were looking ahead last fall, and that is always a risk when any of us try to do that. But it seems to me it is one thing to make ballpark guesses in a speech, and quite another to do it in the budget. And one of the things that puzzles me about the fiscal 1985 budget is the general willingness to wait until next year or even later to prescribe the revenues that most economists outside the White House believe are necessary.

BUDGET PACKAGE WITH ADJUSTMENTS IS NEEDED

I think we ought to really get the issue clearly before us. The issue is not over which party wants to raise taxes. And taxes alone are certainly not the answer to the deficit problem. The answer seems to be a budget package which includes adjustments to those items which can bring down the deficit. And unless we adjust taxes and entitlement expansions, and keep the lid on the balance of domestic spending, those deficits are not going to get any smaller.

But whenever the issue of revenue comes up, it is not because of some great urge to boost taxes. None of us on either side of the aisle do not like to be urging that. It only comes because the administration continually ropes off both taxes and defense as part of the deficit-cutting package.

Spending helped get us into the deficit mess, and spending cuts will help get us out. Military spending and declining revenues also helped get us into the mess, and they are going to have to help get us out, too.

Everything in the budget has to be on the summit table when those deficit talks begin. In your testimony today, I hope you will help set the stage for some serious work. We need to get a clear picture of how we can realistically expect the economy to perform during the next few years, and we need to get some idea that the entire budget is open to serious negotiation. So far, it seems both of these prospects are under a cloud cover, and I hope you can help us to clear that cover today.

Senator **Kassebaum**. We are looking forward to hearing your testimony, Mr. Secretary.

Senator **Riegle**. Madam Chairman, are the rest of us going to have the chance to make opening comments?

Senator **Kassebaum**. I think as the questioning comes around, then there will be a chance to express views at that time.

Senator **Riegle**. Well, that is not the way we proceeded yesterday, as you know, and I wanted to be certain, because we do not get the Secretary of the Treasury very often. And I do not know how long he plans to stay, or how many rounds there are going to be, but if this is going to be a serious hearing, I want to make sure there is an opportunity to get these issues on the table.

Senator **Kassebaum**. I am sure there will be.

Senator **Riegle**. Might I ask how long the Secretary intends to stay?

Secretary **Regan**. As long as the gentleman wishes me to stay. I am perfectly willing to stick around and answer questions for as long as the hearing will last. I would not want, of course, to usurp Chairman Feldstein's time.

Senator **Metzenbaum**. Madam Chairman, I do not have an opening statement, but I gather that at least one of my colleagues does. And I would just like to go on record on a day when I do not have an opening statement, to say that I have always thought that the U.S. Senate was a body where we have equals among equals, and that there is no propriety in just permitting two Members to make opening statements and to preclude the other members from doing so. I have said it before, and I want to repeat it again.

Senator **Kassebaum**. I have no problem. No one had told me anyone else had an opening statement, and I was just trying to expedite matters so we could get to the questioning.

Senator Riegle, did you have an opening statement? I do not believe anyone else does on this side.

OPENING STATEMENT OF SENATOR RIEGLE

Senator **Riegle**. Well, I have a brief statement I would like to make, Madam Chairman, and I just assumed we were going to do it the way we did it yesterday. I had no reason to think the procedure had changed.

Secretary Regan, there is one thing that I hope you will address in your opening comments, and that is why I would like to lay it out for you now.

As you know, President Reagan promised that he would be balancing the budget by 1984. That was a very often-repeated pledge and statement, and an entire economic plan was devised in order to see that we would eliminate the deficit and have a balanced budget by the year 1984.

NATIONAL DEBT HAS DOUBLED

Well, we are here in 1984, and we not only do not have a balanced budget, we have the biggest deficits that we have ever had in our history. And as a matter of fact, you are here today in behalf of the budget request, where you are asking for another $180 billion deficit. That is the official request of the President right now that is before us, presented yesterday. And if we pass that budget today without any changes, we will have at least another $180 billion deficit on top of all the deficits that we have seen thus far.

During the period of the Reagan years, we are going to find that the national debt has doubled; rather than having stopped its growth, it actually will have increased by 100 percent. It is a staggering fact. And I know as a person from a financial background, that that has to worry you; but it certainly, I think, worries everybody here.

And I think you owe us an explanation as to what went wrong, why it is that these massive deficits, which were not part of the plan and not part of the commitment that was made, have happened, and why we are now in a situation where we see these deficits continuing on out into the future as far as the projections go in the $200 billion a year range.

And if the plan has not been able to work properly, not the way it was advertised, not the way we had all hoped that it would, I think we have to know why it did not work, so we are in a position to figure out a way to fix it. So I would hope that you would find a way in your opening comments to indicate what did go wrong and why we have these massive continuing deficits.

Thank you.

Senator **Kassebaum**. Mr. Secretary

STATEMENT OF HON. DONALD T. REGAN, SECRETARY OF THE TREASURY

Secretary REGAN. Thank you, Madam Chairman and members of the committee. It is a pleasure to meet with you to discuss the state of the economy, the near-term outlook, and the budget.

ECONOMY HAS MADE STRONG RECOVERY

The economy has made a strong recovery and is poised for a long period of expansion without a return to high rates of inflation.

It is too easily forgotten just how difficult the economic situation had become by the beginning of this decade, and how much progress has been made in a few short years.

During 1980, real GNP actually fell. During 1983, it rose by 6.1 percent. Only 2 years in the last 20 have posted a larger gain.

During 1980, employment fell by about 400,000 persons. During 1983, it rose by $4 million—the second-largest rise during a calendar year in more than three decades. Nearly 105 million Americans are at work—a record number.

Real compensation, that is wages plus fringes, before taxes fell by about 2.5 percent in 1980, and by an estimated 3 percent in terms of take-home pay. Real compensation rose by 2 percent in 1983, before tax, and by more than 2¾ percent in terms of take-home pay. The real wage gains posted in 1982 and 1983 were the first since a narrow pretax increase was recorded in 1978.

During 1980, consumer prices rose by nearly 12½ percent. During last year, the rise was 3.8 percent. Chart 1,[1] my first chart, shows that this is the best since 1972. You can see where we are in the Consumer Price Index as of the end of the year, right over here, and that compares favorably with any year since the 1960's, except perhaps in this 1972 era.

The rise in producer prices was only six-tenths of 1 percent in 1983, the best in nearly 20 years.

In 1980, the bank prime rate hit a peak of 21.5 percent by year end. Today, the prime rate is at 11 percent.

The administration's economic program is paying dividends now in the form of more jobs and a rising standard of living.

ECONOMIC RECOVERY IS SUSTAINABLE

We believe the economic recovery is sustainable. A 6.1 percent real growth rate in 1983 was a good performance for the first year of economic recovery. By the fourth quarter, growth had moderated to an annual rate of 4.5 percent. In conjunction with good inflation performance, this should reduce any concern that the economy is growing too fast.

Currently, the recovery shows no signs of overheating. To keep the recovery proceeding at its present, sustainable, noninflationary pace, the administration supports moderate, stable, noninflationary money growth rates. This is not always easy to achieve, but it is essential.

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[1] See p. 129.

Several crucial steps have already been taken, primarily in the tax area, to insure a long recovery.

1. Marginal income tax rates have been sharply reduced from the levels they would have reached under prior law, although some of the reductions from 1980 levels have already been offset by bracket creep and higher payroll taxes.
2. Starting in 1985, taxpayers no longer will be pushed into higher and higher tax brackets by the combination of inflation and a progressive tax structure. We will not permit inflation to repeal the incentives we have created.
3. The rates in capital gains have been reduced again, on top of the reductions passed in 1978.
4. The tax treatment of depreciation has been restructured to encourage capital spending.

ECONOMIC OUTLOOK VERY ENCOURAGING

The outlook for 1984 as described in the budget is very encouraging. Real GNP is projected to grow at a 4.5 percent rate between the fourth quarter of 1983 and the fourth quarter of 1984. Inflation of 5 percent is expected during 1984, as measured by the GNP deflator. There are no signs of any new outbreak of inflation. The rate of unemployment is projected to decline further in 1984, to 7.7 percent by the fourth quarter of the year. It is crucially important to keep the unemployment rate declining, as indeed it did last month. High rates of unemployment impose heavy costs on the individuals and families involved.

DEFICIT WAS FINANCED WITHOUT UNDUE DIFFICULTY

The Federal deficit was financed in 1983 without undue difficulty or extreme pressure on financial markets. The financing needs of U.S. businesses and consumers have readily been met, despite the deficit financing demands of the U.S. Government. Improvement in the corporate financial picture has been a major influence. Higher corporate cash flow enabled corporations to improve their balance sheets and increase their liquidity, without making heavy net demands on the debt markets.

Difficulties would indeed arise if the Federal deficit were to remain very large at a time when private demands for credit were also high and rising. This appears quite unlikely to be the case in 1984 and may not be in 1985, but the risk is there and should be avoided.

HALF OF DEFICIT DUE TO LINGERING EFFECTS OF RECESSION

About half of the current Federal budget deficit is due to the lingering effects of the recession. That portion of the deficit need not be a cause for lasting concern, since it can be removed by the gradual recovery of the economy. Unfortunately, the remaining structural deficit will rise over the next several years, unless action is taken to curb it.

The structural deficit is not due to the 1981 tax cuts. Those tax cuts simply hold the ratio of receipts to GNP in an accustomed historical range—18 to 20 percent of gross national product. Taxes would have climbed to about 24 percent of GNP by 1988, in the absence of those 1981 tax cuts and tax indexing. Reversal of those tax cuts would only impede the recovery.

This point can be made in very practical terms for individual taxpayers. Chart 2[1] shows the situation for a family of four, with $25,000 of income. If the 1980 tax law had simply been extended forward, their real tax burden in 1982 dollars would have increased by nearly 25 percent by 1988—a rise of about $1,000 in 1982 terms. Under current law, the real tax burden of the family remains approximately constant as a proportion of income at about the 1980 level, as you can see from the black line on the chart. The orange line on the chart represents 1980 law merely projected forward. This green line represents the effects of repeal of indexing, which would carry the tax burden up for an average family.

As table 1[2] shows, the Economic Recovery Tax Act of 1981, ERTA, was needed largely to offset ongoing tax increases, and its net impact has been reduced further by subsequent legislation. Over the fiscal 1981-89 period, ERTA reduced taxes by $1,488 billion. Over the same period, bracket creep from inflation would have raised taxes by $650 billion; the 1977 Social Security Amendments add about $288 billion; TEFRA, about $311 billion; the Surface Transportation Act, $28 billion; the 1983 Social Security Amendments, $90 billion; and $9 billion in miscellaneous increases. These total $1,375 billion, leaving a net tax cut of $113 billion over 9 years, or only $12.6 billion per year.

TAX BASE NOT DESTROYED

We have leveled taxes off as a share of gross national product. We have not destroyed the tax base, as some have charged. We have merely said to Washington and the Congress, "Thus far and no farther."

The deficit problem has been created by a failure to control Government spending, which has been a steadily rising share of GNP. Chart 3[3] summarizes the fiscal situation for the economy as a whole. Receipts will average at or about historical levels over the next 5 years, in spite of the Reagan tax cuts, as you can see right here from the green line on the chart.

From 1964 to 1979, receipts averaged about 18.8 percent. In fiscal years 1985-89, receipts are projected to rise from 19.2 percent to 19.9 percent of GNP. Outlays are substantially above the historical levels. From 1964 to 1979, outlays, on and off budget, averaged 20.5 percent of gross national product. For fiscal 1985 through fiscal 1989, they are expected to fall from 23.8 percent to 22.1 percent—that is the black line on the chart—and from 24.2 percent to 22.2 percent, including the off-budget outlays. High outlays through a failure to control the growth of Federal spending and low GNP because of the recession are the sources of the projected deficits.

The best way to cure the out-year deficit problem is to cut the growth of spending. It is Government spending which diverts resources to the Government from the private sector, whether financed by borrowing or taxing. In addition, taxes reduce the growth of output by lowering the after-tax rate of return in the private sector. The choice between taxing and borrowing is a choice between two undesirable alternatives. The necessity for that choice would not arise if Government spending were placed under effective control. The budgetary problem must be solved primarily on the spending side.

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[1] See p. 131.
[2] See p. 132.
[3] See p. 134.

$180.4 BILLION BUDGET DEFICIT PROJECTED

The projected budget deficit is $180.4 billion in 1985. The deficit is expected to remain at about the same level for the next 2 years—$177 billion in 1986 and $180.5 billion in 1987—and then declines to $152 billion in 1988 and $123 billion in 1989.

Chart 4[1] shows the rise in the deficit in the recent recession and the projected decline as a percentage of GNP through 1989. From the chart you can trace the deficits, starting in 1975. They peak in 1983, as a share of GNP, dip in 1984 under the current projections, and then decline through 1989.

This is major progress, but we can and we must do better. Further progress in restraining spending and deficits will be difficult in an election year. Nonetheless, we must make a beginning, a downpayment, to show our continued determination to bring the out-year deficits down, but we must do so in a way consistent with the continuation of economic growth.

The President is sincerely interested in making a downpayment. That is why he has called for the bipartisan development of a downpayment deficit reduction plan. He would like this to be comprised of some of the less contentious spending cuts still pending before the Congress, combined with certain measures to close tax loopholes and additional outlay savings based on the Grace Commission. This downpayment would reduce the deficit by at least $100 billion over the next 3 years. Several proposals for deficit reduction are contained in the President's budget. Additional suggestions from the Congress will be welcome.

Assuming that this downpayment is made, and that the Federal Government moves toward balance, and that the Federal Reserve can achieve and maintain a relatively steady and moderate rate of advance in money, the opportunity will exist for lengthy, sustained economic expansion.

Other major steps toward promoting savings incentives, efficiency, and tax fairness can and should be taken in the years ahead. In his state of the Union message, the President directed me to develop a plan of action to simplify the entire tax code, so all taxpayers, big and small, are treated more fairly. The objectives of this plan include improved compliance and a broader tax base, so that tax rates can be lowered. I will present a set of specific recommendations to the President by December 1984.

The President has also stated that better control over Government spending can be achieved if better tools are available. Toward that end, the President is requesting a constitutional amendment to require a balanced budget, and a constitutional amendment to provide him with line item veto authority.

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[1] See p. 136.

The President's budget proposal would reduce the current services deficits by about $105.8 billion over the fiscal 1985–87 period. The committee heard yesterday from Budget Director Stockman about the spending proposals. I will concentrate on receipts.

BUDGET RECEIPTS SHOW INCREASE

Total budget receipts in fiscal 1985 are estimated to be $745 billion, an increase of $75 billion from the $670 billion estimated for 1984. Of this $75 billion increase, $67.3 billion, almost 90 percent, reflects the effects of economic growth.

The composition and growth of receipts is shown in my last chart, chart 5,[1] of the submitted testimony. In 1985, income taxes paid by individuals and corporations are estimated to be $328.4 billion for individuals, $76.5 billion for corporations. Individuals and corporations together, account for about 54 percent of the estimated budget receipts. Social insurance taxes paid by employers and employees are expected to yield another $271 billion, or 36 percent of the total. Excise taxes are expected to provide $38.4 billion, about 5 percent of the total, and the rest is accounted for by estate and gift taxes, customs duties, and miscellaneous receipts. Budget receipts are projected to increase to $815 billion in 1986, $888 billion in 1987.

Now, turning to the revenue proposals in the administration's budget, we estimate they will increase receipts by almost $8 billion in 1985, $11.6 billion in 1986, and $14.2 billion in 1987, or a total of approximately $34 billion in new revenues.

The administration is calling for no new across-the-board tax increases. They are not needed, nor are they justified, in light of our current economic conditions.

We are also introducing new initiatives designed to reduce unintended tax benefits and to improve the equity and fairness of the tax system, promote the fair treatment of families, foster research and experimentation, and respond to certain international concerns.

Madam Chairman, a detailed description of these proposals is contained in my submitted testimony. I would be pleased to answer any questions that the committee might have.

Thank you.

Senator KASSEBAUM. Thank you very much, Mr. Secretary.

[The prepared statement of Secretary Regan follows:]

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[1] See p. 137.

FOR RELEASE UPON DELIVERY
EXPECTED AT 9:30 A.M.
Friday, February 3, 1984

TESTIMONY OF THE HONORABLE
DONALD T. REGAN
SECRETARY OF THE TREASURY
BEFORE THE SENATE BUDGET COMMITTEE

Mr. Chairman and Members of the Committee:

It is a pleasure to meet with you to discuss the state of the economy and the near-term economic outlook, and the budget.

The economy has made a strong recovery and is poised for a long period of expansion without a return to high rates of inflation. The rise last year in producer prices was the lowest in nearly twenty years. The increases in consumer prices in 1982 and 1983 were the lowest in more than a decade. Yet the economy grew strongly last year and the decline during the year in the rate of unemployment was larger than during any year in more than three decades. Unemployment remains too high but is being reduced rapidly by the dynamic growth of the private sector.

Economic Overview

It is too easily forgotten just how difficult the economic situation had become by the beginning of this decade and how much progress has been made in a few short years. While not all indicators showed improvement, the magnitude of the gains since 1980 in most key areas is striking indeed.

- During 1980, real GNP actually fell. During 1983 it rose by 6.1 percent. Only two years in the last twenty have posted a larger gain.
- During 1980, employment fell by about 400 thousand persons. During 1983 it rose by 4 million, the second largest rise during a calendar year in more than three decades. Over 104 million Americans are at work, a record number.
- In 1980, money compensation per hour (wages plus fringes) rose by about 10-1/2 percent, but that apparent gain and more besides was chewed up by inflation. Real compensation before taxes fell by about 2-1/2 percent in 1980 and by an estimated 3

percent in terms of take-home pay. Real compensation rose by 2 percent in 1983 before tax and by 2-3/4 percent in terms of take-home pay. The real wage gains posted in 1982 and 1983 were the first since a narrow pre-tax increase was recorded in 1978.

- During 1980, consumer prices rose by nearly 12-1/2 percent. During last year the rise was 3.8 percent. Chart 1 shows that is the best since 1972, when prices were artificially held down by price controls, and the best since 1967 for a year without price controls. As Chart 1A shows, the rise in producer prices was only 0.6 percent in 1983, the best in nearly twenty years.
- In 1980, the bank prime rate of interest hit a peak of 21-1/2 percent by year end. Today, the prime rate is 11 percent.

The Administration emphasis on controlling inflation and the stimulation of private sector growth is paying dividends now in the form of more jobs and a rising standard of living.

Extending the Recovery

We believe the economic recovery is sustainable. The 6.1 percent real growth rate in 1983 was a good performance for the first year of economic recovery. By the fourth quarter, growth had moderated to an annual rate of 4.5 percent. In conjunction with good inflation performance, this should reduce any concern that the economy is growing too fast.

Currently, the recovery shows no signs of overheating. A stable, moderate growth rate of money and credit is important to keep the recovery proceeding at its recent sustainable, non-inflationary pace. The Administration supports moderate, stable non-inflationary money growth rates. This is not always easy to achieve, but it is essential.

Now that a cyclical recovery is well under way it is time to give more attention to the long-run performance of the economy. We need to shape our policies over the longer term to reinvigorate the private sector.

Several crucial steps have already been taken, primarily in the tax area, to ensure a long recovery.

- Marginal income tax rates have been sharply reduced from the levels they would have reached under prior law, although some of the reductions from 1980 levels have already been offset by bracket creep and higher payroll tax rates. Work, saving and investment incentives have been enhanced, and the use of tax shelters and the underground economy discouraged.

- Starting in 1985, taxpayers no longer will be pushed into higher and higher tax brackets by the combination of inflation and a progressive tax structure. We will not permit inflation to repeal the incentives we have created.
- The rates on capital gains have been reduced again on top of the reductions passed in 1978.
- The tax treatment of depreciation has been restructured to encourage capital spending.

The Economic Outlook

The strength of last year's recovery and the progress made against inflation reflects the resilience and adaptibility of our economic system when proper policies are followed. If the same policy direction is maintained in future years, the current recovery can be extended and a clear break can be made with the past. The long period of sluggish growth and rising inflation can be brought to an end.

The outlook for 1984 as described in the budget is very encouraging.

- Real GNP is projected to grow 4-1/2 percent between the fourth quarter of 1983 and the fourth quarter of 1984.
- Inflation of 5 percent is expected during 1984, as measured by the GNP deflator. There are no signs of any new outbreak of inflation.
- The rate of unemployment is projected to decline further in 1984, to 7.7 percent by the fourth quarter of the year. It is crucially important to keep the unemployment rate declining. High rates of unemployment impose heavy costs on the individuals and families involved.

Financing the Budget Deficit

The Federal deficit was financed in 1983 without undue difficulty or extreme pressure on the financial markets. The financing needs of U.S. businesses and consumers have readily been met despite the deficit financing demands of the U.S. Government. Improvement in the corporate financial picture has been a major influence. Corporate cash flow more than covered corporate capital expenditures last year; and corporations sold a record volume of new stock issues. Hence, corporations were able to improve their balance sheets and increase their liquidity without making heavy net demands on the debt markets.

Difficulties would indeed arise if the Federal deficit were to remain very large at a time when private demands for credit were also high and rising. This appears quite unlikely to be the case in 1984, and may not be in 1985, but the risk is there and should be avoided.

Source of the Deficit

Our ability to deal effectively with the deficit problem has been hampered by basic confusion over the cause of the deficits. About half of the current Federal budget deficit is due to lingering effects of the recession. That portion of the deficit need not be a cause for lasting concern since it can be removed by the gradual recovery of the economy. However, the remaining deficit -- sometimes termed structural -- would be left to deal with even after a cyclical recovery. Unfortunately, this remaining structural deficit will rise over the next several years unless action is taken to curb it.

The structural deficit is not due to the 1981 tax cuts. Those tax cuts simply hold the ratio of receipts to GNP in an accustomed historical range -- 18% to 20% of GNP. Taxes would have climbed to about 24 percent of GNP by 1988 in the absence of the 1981 tax cuts and tax indexing. Reversal of those tax cuts would only impede the recovery.

This point can be made in very practical terms for individual taxpayers. Chart 2 shows the situation for a family of four with a $25,000 income. If the 1980 tax law had simply been extended forward, their real tax burden (in 1982 dollars) would have increased by nearly 25% by 1988 -- a rise of about $1,000 in 1982 dollars. Under current law, the real tax burden of the family remains approximately constant as a proportion of income at about 1980 levels.

In fact, as Table 1 shows, the Economic Recovery Tax Act of 1981, ERTA, was needed largely to offset ongoing tax increases, and its net impact has been reduced further by subsequent legislation. Over the FY 1981 - FY 1989 period, ERTA reduced taxes by fourteen hundred eighty-eight billion dollars. Over the same period, bracket creep from inflation would have raised taxes by $650 billion; the 1977 Social Security Amendments add $288 billion; TEFRA, $311 billion; the Surface Transportation Act, $28 billion; the 1983 Social Security Amendments, $90 billion; and $9 billion in miscellaneous increases. These total $1375 billion, leaving a net tax cut of $113 billion, over 9 years, or only $12.6 billion per year. We have leveled taxes off as a share of GNP. We have not destroyed the tax base, as some have charged. We have merely said to Washington and the Congress, "Thus far and no farther."

The deficit problem has been created by a failure to control government spending, which has taken a steadily rising share of GNP. Chart 3 and accompanying Table 2 summarize the fiscal situation for the economy as a whole. Receipts will average at or above historical levels over the next five years in spite of the Reagan tax cuts. From 1964 to 1979, receipts averaged 18.8 percent of GNP. In FY 1985 - 1989, receipts are projected to rise from 19.2 percent to 19.8 percent of GNP. Outlays are substantially above historical levels. From 1964 to 1979, outlays on and off budget averaged 20.5 percent of GNP. In FY 1985 - 1989, they are expected to fall from 23.8 percent to 22.1 percent of GNP, on budget, and from 24.2 percent to 22.2 percent including off-budget outlays. High outlays, through a failure to control the growth of Federal spending, and low GNP, because of the recession, are the source of the projected deficits.

The best way to cure the outyear budget deficit problem is to cut the growth of spending. It is government spending which diverts resources to the government from the private sector, whether financed by borrowing or by taxing. In addition, taxes reduce the growth of output by lowering the after-tax rate of return in the private sector. The choice between taxing and borrowing is a choice between two undesirable alternatives. The necessity for that choice would not arise if government spending were placed under effective control. The budgetary problem must be solved primarily on the spending side.

The Budget Deficit

The projected budget deficit is $180.4 billion in 1985. The deficit is expected to remain at about the same level for the next two years -- $177.1 billion in 1986 and $180.5 billion in 1987 -- and then decline to $152.0 billion in 1988 and $123.4 billion in 1989. Chart 4 shows the rise in the deficit in the recent recessions and the projected decline, as a percentage of GNP, through 1989. This is major progress, but we can and must do better.

Genuine lasting reduction in the growth rate of Federal spending has been very difficult to achieve. It will be doubly difficult in an election year for reasons which hardly require extended elaboration. Nonetheless we must make a beginning, a downpayment to show our continued determination to bring the outyear deficits down, but we must do so in a way consistent with the continuation of economic growth.

The President is sincerely interested in making a downpayment. That is why he called for the bipartisan development of a downpayment deficit reduction plan. He would like this to be comprised of some of the less contentious spending cuts still pending before the Congress, combined with certain measures to close tax loopholes and additional outlay savings based on the Grace Commission. This downpayment could reduce the deficit by at least $100 billion over the next 3 years. Several proposals for deficit reduction are contained in the President's budget. Additional suggestions from the Congress will be welcome.

Assuming that this downpayment is made, and that the Federal budget moves toward balance, and that the Federal Reserve can achieve and maintain a relatively steady and moderate rate of advance in money, the opportunity will exist for a lengthy sustained economic expansion.

Other major steps toward promoting savings incentives, efficiency and tax fairness can and should be taken in the years ahead. In his State of the Union Message, the President directed me to develop a plan of action to simplify the entire tax code, so all taxpayers, big and small, are treated more fairly. The objectives of this plan include improved compliance and a broader tax base so that tax rates can be lowered. I will present a set of specific recommendations, consistent with these objectives, to the President by December, 1984.

The President has also stated that better control over government spending can be achieved if better tools are made available. Toward that end, the President is requesting a Constitutional Amendment to require a balanced budget, and a Constitutional Amendment to provide him with line item veto authority.

Budget Outlays and Proposals

Budget outlays (on budget) in FY 1985 are estimated to be $925.5 billion, an increase of $71.7 billion from the $853.8 billion estimated for 1984. This is an increase of 8.4 percent. In real terms (1972 prices), the increase is about $11.9 billion, or 3.3 percent, of which about $9 billion (about 75 percent) is for defense -- nondefense outlays grow only about 1 percent in real terms for FY 1985 compared to the FY 1984 estimate.

Over the next three years (FY 1985-1987), the Administration's budget proposals will reduce current services outlays on domestic programs by $48.7 billion. Current services defense outlays would be reduced by $27.7 billion and receipts would rise by $33.5 billion. Spending increases are planned in the areas of international affairs, space and science, law enforcement and veterans benefits. They amount to $17.9 billion. Interest saving on the net deficit reductions would be $13.8 billion. Thus, the President's budget proposals would reduce the current services deficit by about $105.8 billion over the FY 1985-1987 period.

Budget Receipts

Total budget receipts in 1985 are estimated to be $745.1 billion, an increase of $75.1 billion from the $670.1 billion estimated for 1984. Of this $75.1 billion, $67.3 billion, almost 90 percent, reflects the effects of economic growth.

In 1985, income taxes paid by individuals and corporations are estimated to be $328.4 billion and $76.5 billion, respectively, and together account for 54.3 percent of estimated budget receipts. Social insurance taxes paid by employers and employees are expected to yield another $270.7 billion, or 36.3 percent of the total; excise taxes are expected to provide $38.4 billion (5.2 percent); and the remaining $31.1 billion (4.2 percent) are accounted for by estate and gift taxes, customs duties, and miscellaneous receipts. Budget receipts are projected to increase to $814.9 billion in 1986 and $887.8 billion in 1987. The composition and growth in receipts is shown in Chart 5.

Revenue Proposals

The proposals in the Administration's budget will increase receipts by $7.9 billion in 1985, $11.6 billion in 1986, and $14.2 billion in 1987, for a total of approximately $34 billion.

The Administration is calling for no new across-the-board tax increases. They are not needed, nor are they justified in light of current economic conditions. The budget does, however, call for a number of changes in the tax code that reflect necessary reform, including the closing of loopholes that allow some to pay less than their fair share of taxes.

The tax initiatives in the President's budget fall into two broad categories. First, we are reproposing, with some modifications, several items contained in last year's budget submission that Congress did not enact. These proposals are needed to revitalize areas of economic distress, strengthen education, and control health care costs. We also are introducing new initiatives designed to reduce unintended tax benefits and improve the equity and fairness of the tax system, promote the fair treatment of families, foster research and experimentation, and respond to certain international concerns.

Let me now discuss some of the details of these proposals.

Reintroduced Proposals

Health Care Cap. The Administration proposes to limit the amount of employer-paid health insurance premiums that may be excluded from income and social security taxes. This exclusion creates inequity among employees who receive compensation packages of equal value, but pay quite different amounts of income tax because they receive different amounts of employer-provided health benefits. The exclusion also has encouraged the expansion of elaborate health insurance plans as a substitute for taxable compensation. Over the years this substitution has eroded the income tax base and contributed to the rising cost of medical services. Effective January 1, 1985, health insurance premiums in taxable income to the extent that they exceed $175 per month for family plans and $70 per month for premiums paid under current (but not future) union contracts will continue to be excluded from taxation. This cap would not prevent purchase of adequate coverage; for example, many of the standard plans offered by employers today have total premium costs below the cap.

Our estimates indicate that only 22 percent of employees will be affected by this limitation in 1985. Not surprisingly, affected taxpayers would be concentrated in higher income levels. Whereas fewer than 10 percent of returns with adjusted gross income below $20,000 would be affected, about 40 percent of returns with AGI above $35,000 would be affected.

Enterprise Zone Legislation. This proposal is similar in all basic elements to the proposal we made last year, except for the effective dates, and very similar to the bill previously reported out of this Committee. It is designed to create a productive free-market environment in economically distressed areas by reducing taxes, government regulations, and other government burdens on economic activity. The program includes Federal tax incentives specially designed to encourage the formation of capital and the creation of jobs, with special emphasis on hiring disadvantaged workers. This is a fresh approach to promoting economic growth in inner cities. Instead of relying heavily on government grants, which often have proven inefficient and ineffective, the enterprise zone approach concentrates on freeing private enterprises to produce, create jobs, and expand.

Tuition Tax Credits. To expand opportunities for families, and to ease the burden of the double payment for those paying public school taxes and private school tuition, the Administration also is reintroducing a proposal to allow taxpayers a credit against their income taxes equal to 50 percent of tuition costs for each child in a private elementary or secondary school. The provisions of this proposal are identical to those contained in a previous Senate Finance Committee bill except that the credit will phase out at income between $40,000 and $60,000 of adjusted gross income, as we originally proposed in 1982, rather than between $40,000 and $50,000, as agreed to by this Committee. The maximum credit per child will be $100 in 1984, $200 in 1985, and

$300 in 1986 and thereafter. The Administration supports the strong anti-discrimination provisions adopted by the Senate Finance Committee last year.

Education Savings Accounts. To help low- and middle-income families pay future higher education expenses of their children, taxpayers will be permitted a tax exclusion for the earnings on savings deposited in special education savings accounts. The maximum annual contribution to these accounts will be limited to $1,000 per child. This ceiling will be reduced five cents for each dollar that the taxpayer's adjusted gross income in the prior year exceeds $40,000. Thus, no deposits could be made by families with more than $60,000 of income.

Expenses may be paid out of savings held in these accounts for tuition and room and board of full-time dependent children enrolled in undergraduate degree programs in schools that do not follow a policy of racial discrimination. These expenses must be paid directly to the university or college. Savings withdrawn for any other purpose will be assessed a penalty, except for amounts withdrawn as a result of a child's death or unusual medical expenses incurred by the child.

In order to encourage families to begin saving early for a child's higher education, deposits may be placed in these special savings accounts on behalf of any dependent children under the age of 18. In no case may an account be kept open for a child over the age of 26.

New Initiatives

Family Initiatives. The President has endorsed a package of tax proposals intended to promote the fair treatment of families under the tax system. In recognition of the important economic contributions made by spouses who do not work outside the home, the combined limit for contributions to individual retirement accounts (IRA's) for a husband and wife in such instances will be increased from $2,250 to $4,000. Every married couple that files a joint return thus will be able to deduct annual IRA contributions up to the lesser of $4,000 or 100 percent of the annual compensation received by the couple. In addition, alimony will be treated as compensation in determining the IRA deduction limit applicable to divorced individuals.

Dependent care organizations play an important role in enabling individuals, especially women, to continue their careers. We are proposing that tax-exempt status be provided to any nonprofit, dependent care facility if it is operated to provide nonresidential care, substantially all of the dependent care is provided to enable individuals to be gainfully employed, and the services provided are available to the general public. The dependent care credit available to low- and middle-income taxpayers also will be increased, with the credit available to high-income taxpayers reduced. Those taxpayers with adjusted gross incomes of $60,000 or more would receive no credit.

Research and Experimentation. Industry should be encouraged to undertake research and experimentation that may lead to productivity-enhancing innovation. To enable taxpayers to plan their R&E activities with certainty that the credit will be available, the Administration proposes to extend the R&E credit through 1988. The definition of R&E will be modified to target the credit more effectively.

To maintain current incentives for R&E conducted in the United States pending further consideration, we propose to extend for two years the moratorium on the application of Treasury regulations relating to allocations of R&E to foreign source income.

Response to International Concerns. First in this category of proposals is the introduction of a withholding system with respect to taxes on gains of foreign persons on the sale of U.S. real property. This proposed withholding system will significantly increase compliance with U.S. tax law by foreign sellers of U.S. real property interests.

In order to alleviate concerns expressed by members of the General Agreement on Tariffs and Trade (GATT) concerning the present tax deferral available to domestic international sales corporations, we propose to replace that system with a new system for taxing export sales income. This new system is intended to preserve the competitiveness of U.S. exports while addressing concerns expressed by other GATT members. We appreciate the cooperation of this Committee in scheduling hearings on this important legislation for tomorrow.

Finally, in recognition of the sacrifice that members of the U.S. Armed Forces and employees of the U.S. government must be prepared to make when they leave our borders, we propose to grant a tax exemption for U.S. military or civilian personnel who die as a result of injuries sustained outside the United States in a terrorist or military action. It is tragic to think of widows of marines killed in Lebanon paying income taxes on their husbands' past wages.

TIM's. The Administration also proposes changes in the tax law necessary to accommodate Trusts for Investment in Mortgages (TIM's). These changes are expected to expand the private secondary mortgage market, attracting additional capital to support long-term mortgage lending activity.

Structural Tax Reform Proposals. The Administration is introducing proposals to reform three areas of the tax law. The first will impose limitations on the availability of ACRS and investment tax credits on certain property leased by Federal, State, or local governments or organizations not subject to U.S. tax. This proposal will prevent the tax shelter-type transactions that have received widespread publicity, such as recent transactions entered into by certain municipalities and colleges. The Committee previously has approved this provision in last year's reconciliation bill, and we are happy to restate our support.

The second of the structural reform proposals involves broad-based improvements in the taxation of life insurance companies and their products. Under this proposal a carefully worked out single-phase system will replace the 25-year old two-phase system of taxing life insurance companies. In addition, "life insurance" will be defined to remove ambiguity concerning certain innovative products that have been introduced by the insurance industry.

Third, the Administration supports proposals that will impose a number of restrictions to limit the alarming growth of private purpose tax-exempt bonds. The total volume of these bonds has grown 570 percent from 1975 through 1982. The revenue loss to the Federal government from these bonds is substantial. For example, we estimate the revenue loss from all outstanding private purpose tax exempt bonds issued in FY 1984 to be over $8 billion dollars. The limitations we propose are similar to the limitations contained in H.R. 4170, as we expect it to be amended by the Ways and Means Committee. The proposals include state-by-state annual volume limitations on industrial development bonds and student loan bonds. The proposal also denies tax-exempt status for bonds guaranteed or backed by certain Federal agencies and subjects obligations issued by Puerto Rico and U.S. Possessions to the rules presently applied to those of State and local governments.

Curtailment of Tax Shelter, Accounting, and Corporate Tax Abuses. We have identified many transactions that are designed to create unintended tax benefits. These transactions frequently are the cornerstone of tax shelter schemes and in most cases involve what we consider misuse of the partnership, accounting, and corporate tax provisions of the Code. We are proposing a number of technical amendments to curtail these transactions.

The proposals will restrict the ability that partners may have under current law to allocate partnership income in abusive transactions. In addition, existing rules that were designed to restrict tax-motivated retroactive partnership allocations will be tightened.

Current tax accounting provisions provide taxpayers with significant flexibility in determining the time at which they must report income and deduction items and the amount of interest that must be charged on loans and deferred payment sales of property. Because the tax code does not adequately address the time value of money, we have seen an alarming number of transactions that abuse this flexibility. These transactions permit taxpayers to accelerate or inflate income tax deductions (for example, by taking a current deduction for the estimated cost of expenses to be paid for in the future) and to claim inflated ACRS allowances and investment tax credits. The proposals will tighten certain of the tax accounting provisions of the Code in order to stop taxpayers from claiming unintended tax benefits.

Several proposals are designed to preclude sophisticated corporate taxpayers from abusing the rules relating to the taxation of corporate dividends, short sales, real estate investment trusts, and regulated investment companies. The rules governing the taxation of transfers of property to foreign corporations will be tightened. We also need to end abuses involving charitable contributions, tax-free exchanges of property, securities straddles, and collapsible corporations.

Miscellaneous Provisions. Finally, the Administration proposes to extend the targeted jobs tax credit and to extend the PIK program to farmers who participate in the 1984 winter wheat program.

Employee contributions to civil service retirement will be increased from 7 percent of wages and salaries to 8 percent effective October, 1984, and to 9 percent effective October, 1985. For District of Columbia employees, the D.C. Government contribution will increase correspondingly. In addition, regular Federal/State unemployment insurance coverage will be extended to railroad employment, effective January 1, 1985.

It should be noted also that the budget adopts the assumption that certain trust fund taxes will be extended even though, under current law, they are scheduled to expire. These trust fund taxes are the Superfund taxes on hazardous substances, which expire at the end of fiscal year 1985, the Airport and Airways Trust Fund taxes, which expire at the end of calendar year 1987 and the Highway Trust Fund taxes, which expire at the end of fiscal year 1988. Our estimate of budget receipts, therefore, includes the extension of these trust fund taxes as well as the tax proposals I have previously enumerated.

Improved Tax Compliance

Failure to comply fully with our tax law benefits a few at the expense of the vast majority of honest taxpayers. We must redouble our efforts to narrow the tax gap between the correct tax liability owed and the amount taxpayers voluntarily pay. As the President indicated in his State of the Union Address, it would be immoral to make those who are paying taxes pay more to compensate for those who aren't paying their share.

We expect that a number of the proposals I have just outlined to curtail tax shelter, accounting, and corporate tax abuses also will improve tax compliance. And the IRS budget we are seeking for FY 1985 includes some 1,900 new positions--$64 million in additional outlays targeted to improve document matching, increase examination efforts, particularly for unincorporated nonfarm businesses, and implement the backup withholding system in the 1983 Interest and Dividend Tax Compliance Act.

We have seen enacted since this Administration took office a number of tough measures to improve compliance. For example, while it is too early to provide specific data on the effect of the recently broadened system of backup withholding, preliminary information indicates that 7 to 10 percent of reported taxpayer identification numbers are in error. Consequently, efforts by payers to obtain accurate numbers in response to the new backup withholding provisions will facilitate improved matching by the Internal Revenue Service of information documents on dividends and interest to tax returns and thereby help narrow the tax gap. Another example is the new tip reporting system enacted in 1982. Following this change, IRS data from Form 941 tax returns show that the amount of taxable tips in the first three quarters of 1983 were more than double the amount in the first three quarters of 1982.

Fundamental Tax Reform

While the new tax initiatives we are introducing are of immediate importance because they improve the equity and fairness of the present system, I would like to turn now to the much broader issue of fundamental tax reform.

Last week, in his State of the Union Message, the President directed me to develop a plan of action to simplify the entire tax code so all taxpayers, big and small, are treated more fairly. The objectives of this plan include improved compliance and a broader tax base so that tax rates can be lowered. I will present a set of specific recommendations, consistent with these objectives, to the President by December 1984.

The President recognizes that the time to act is now. We no longer control the tax system. It controls us.

Since 1980 we have made great strides. We, and by we I mean this Administration, this Committee, and the entire Congress, have moved in the proper direction. We have recognized some of the major problems of the income tax structure we inherited and we have done something about them.

- High individual income tax rates were sapping incentives to work, save, and invest. We cut them 23 percent across the board.

- Bracket creep was taking increasing amounts of after-tax real dollars from the pockets of individual taxpayers with a given real income, even in years when there were no explicit tax increases. We indexed the individual tax structure to eliminate permanently these unlegislated tax increases and to prevent government from raising more revenue simply through inflation.

- An antiquated and complex system of tax depreciation that was inadequate during periods of high inflation was helping to depress the rate of business expansion and modernization. We have replaced this system with a simplified accelerated cost recovery system that assures business the funds needed for capital improvement.

While these changes have halted the continuing rise in marginal tax rates and restored needed overall incentives for capital formation, major structural problems in the current income tax still remain. Therefore, this Administration is committed to consider a major overhaul of our tax structure.

Households and businesses must be allowed to make the best use of the resources at their disposal with a minimum of intrusion by tax considerations. Efficient use of resources requires a tax system that does not interfere with economic decisions in a capricious and haphazard manner. Under our present income tax structure, the size of your tax bill depends not only upon the size of your income but also upon how you earn your income and how you spend your income.

This complexity leads many households and businesses to consult tax planners before making any major decision affecting their pocketbooks. Every decision made on the basis of tax considerations rather than economic considerations is robbing us all each day.

Only with a tax system that does not discriminate among ways of earning and spending money can we achieve the highest attainable level of economic growth. We must recognize that any deviations from this standard will cause the Nation's resources to be allocated in a less than optimal fashion, resulting in lower productivity, a dampened rate of economic expansion, and in the end, a lower standard of living for all.

We already have spent a good deal of time at the Treasury Department during 1982 and 1983 examining ways to make fundamental changes in our current tax structure. We are considering a number of approaches including a consumed income tax -- a broad-base tax on all sources of income with a deduction for net savings, a value-added tax, and various forms of broad-based, low-rate income taxes. At the President's direction, we will intensify our study of these and other tax alternatives over the next 11 months.

By December 1984, I expect to have for the President a set of specific recommendations for fundamental changes in our present income tax structure that will make our system of taxation much simpler, more fair, more neutral, and more efficient while fostering economic growth. If we can develop a system of taxation based on these goals, we will encourage better compliance and reduce the reward for engaging in either tax shelters or the underground economy.

For us at Treasury this will be a year of intensive study. In the course of this study we will have to deal with some very difficult issues associated with any radical transformation of the income tax structure. Some tough and unpopular decisions will be part of the price to pay for a simple, neutral, and equitable system of taxation.

I know that you, Mr. Chairman, and members of this committee recognize that this is a tall order to fill. The present Internal Revenue Code was written over a number of decades. As a result, the tax law has accumulated many patchwork provisions, often designed to meet temporary needs of particular interest groups, that have added to the complexity of the system and distorted economic choices. It is time to take a fresh look at our entire tax system.

Chart 1

CONSUMER PRICE INDEX

(Monthly Data, Percent Change from Year Earlier)

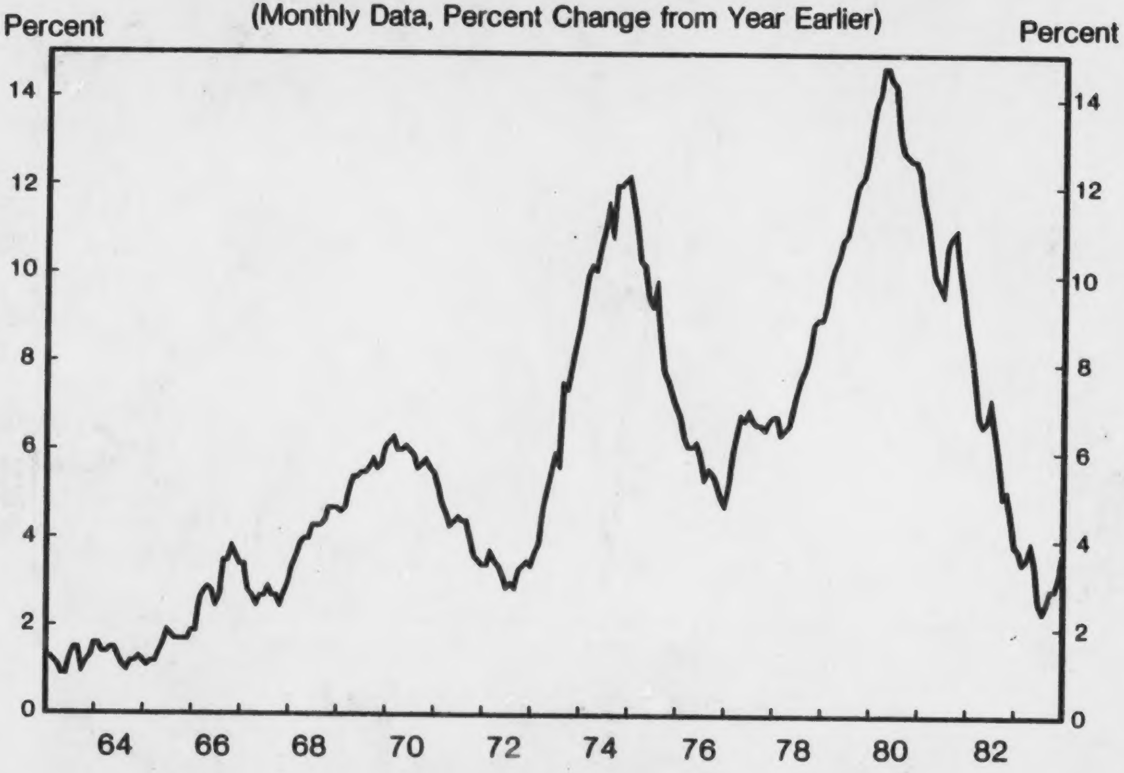


Chart 1a

PRODUCER PRICE INDEX

(Monthly Data, Percent Change from Year Earlier)

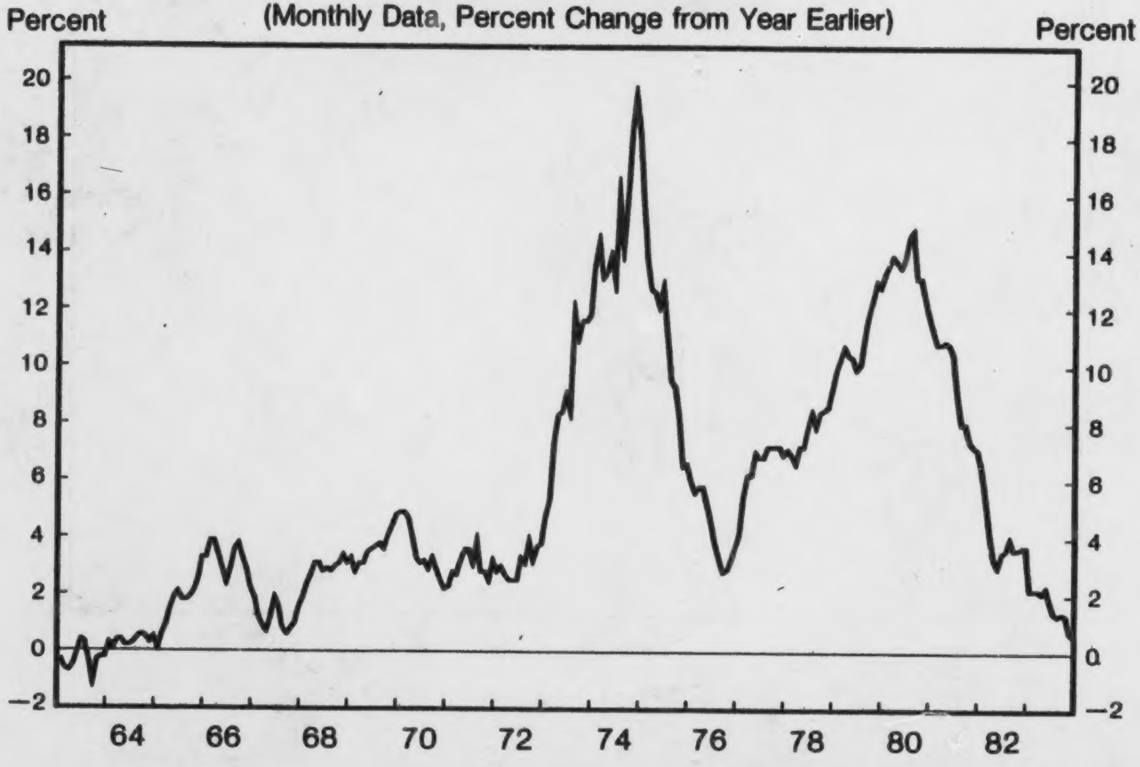
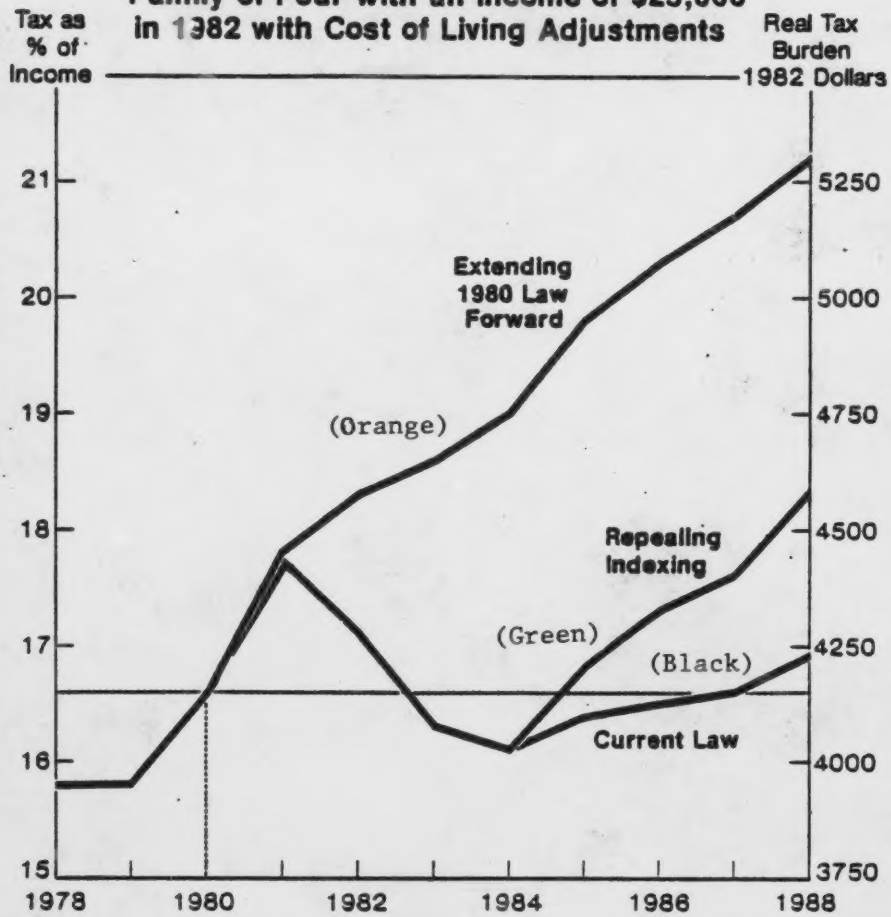


Chart 2



REAL TAX BURDEN
(INCOME & EMPLOYEE PAYROLL TAX)
Family of Four with an Income of $25,000 in 1982 with Cost of Living Adjustments

January 25, 1984-447

Table 1

WHAT IS LEFT OF THE TAX CUT?

FY 1981 — FY 1989

($ billions)

			Fiscal Years 1981 through 1989
Tax Cut:	Economic Recovery Tax Act of 1981 (ERTA)		—$1,488.4 billion
Tax Increases:	Inflation-Induced Bracket Creep	+$649.8	
	1977 Social Security Tax Rate Increases	+$287.5	
	Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)	+$310.6	
	Gasoline Tax Increase	+$ 28.0	
	1983 Social Security Amendments	+$ 90.2	
	Other	+$ 9.1	
Total Tax Increases			+$1,375.2 billion
Net Tax Cut			—$ 113.2 billion
Nine Year Average Net Tax Cut			—$ 12.6 billion

February 2, 1984-A57

Table 1a

A Comparison of the Tax Increases due to Bracket Creep and the Scheduled Social Security Tax Increases with the Tax Changes Enacted During te Reagan Administration

($ billions)

	Fiscal Years									
	1981	1982	1983	1984	1985	1986	1987	1988	1989	Total 1981-1989
Tax increases since 1980 resulting from:										
Bracket creep due to inflation 1/	5.6	25.1	38.5	47.4	60.4	79.0	102.5	130.4	160.9	649.8
Scheduled social security increases 2/	9.8	17.0	19.3	20.9	31.2	39.1	45.8	50.2	54.2	287.5
Total, increases	15.4	42.1	57.8	68.3	91.6	118.1	148.3	180.6	215.1	937.3
Tax changes enacted during the Reagan Administration:										
ERTA (1981)	-0.3	-40.2	-91.1	-133.6	-165.0	-207.7	-248.5	-282.7	-319.2	-1488.4
TEFRA (1982) 3/	--	*	16.5	32.8	37.3	46.8	58.0	59.6	59.6	310.6
Surface Transportation Act (1982) 4/	--	--	1.5	4.1	4.2	4.4	4.5	4.6	4.7	28.0
Social security amendments (1983)	--	--	--	6.2	8.8	9.3	11.4	23.4	31.1	90.2
Other 3/5/	--	--	--	0.2	0.8	1.5	2.1	2.2	2.3	9.1
Total, enacted changes	-0.3	-40.2	-73.0	-90.3	-113.8	-145.7	-172.6	-192.9	-221.6	-1050.5
Net tax change from 1980 Law	15.0	1.9	-15.2	-22.0	-22.2	-27.7	-24.3	-12.3	-6.4	-113.2

February 1, 1984

Office of the Secretary of the Treasury
Office of Tax Analysis

Note: Details may not add to totals due to rounding.
*Less than $50 million.

1/ Amounts shown are the increases in individual income tax receipts (that would have been realized prior to the changes enacted during the Reagan Administration) resulting from inflation induced increases in effective tax rates since 1980.

2/ Effective rate increases from the structure in effect in 1980 (includes changes in the statutory rates in 1981-1989 and the ad hoc increase in the wage base for 1981 enacted in the 1977 social security amendments).

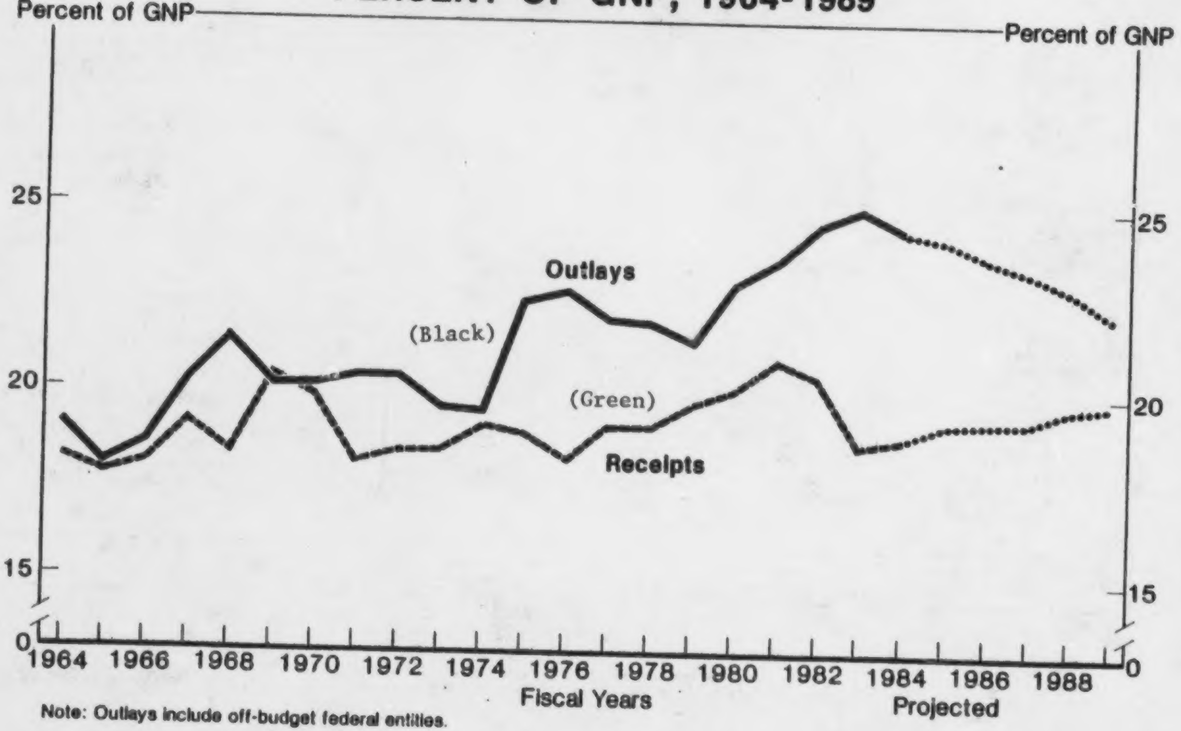
3/ Withholding on interest and dividends is excluded from the revenue effects of TEFRA; revenue effects of backup withholding ($1.1 billion in 1988) are included in "other".

4/ Amounts shown are the effect of the Surface Transportation Act on current services receipts, i.e., the effect of the Act extended beyond the expiration date compared to prior law extended beyond the expiration date.

5/ Railroad Retirement Revenue Act of 1983 and backup withholding only.

Chart 3

OUTLAYS AND RECEIPTS AS PERCENT OF GNP, 1964-1989



Note: Outlays include off-budget federal entities.

January 27, 1984 A313

Table 2

OUTLAYS AND RECEIPTS AS PERCENT OF GNP

	Receipts	Outlays*
1985-1989	19.5	23.3
1984	18.8	24.4
1983	18.6	25.0
1982	20.2	24.4
1981	20.8	23.5
1980	20.1	22.9
1964-1979 (avg.)	18.8	20.5

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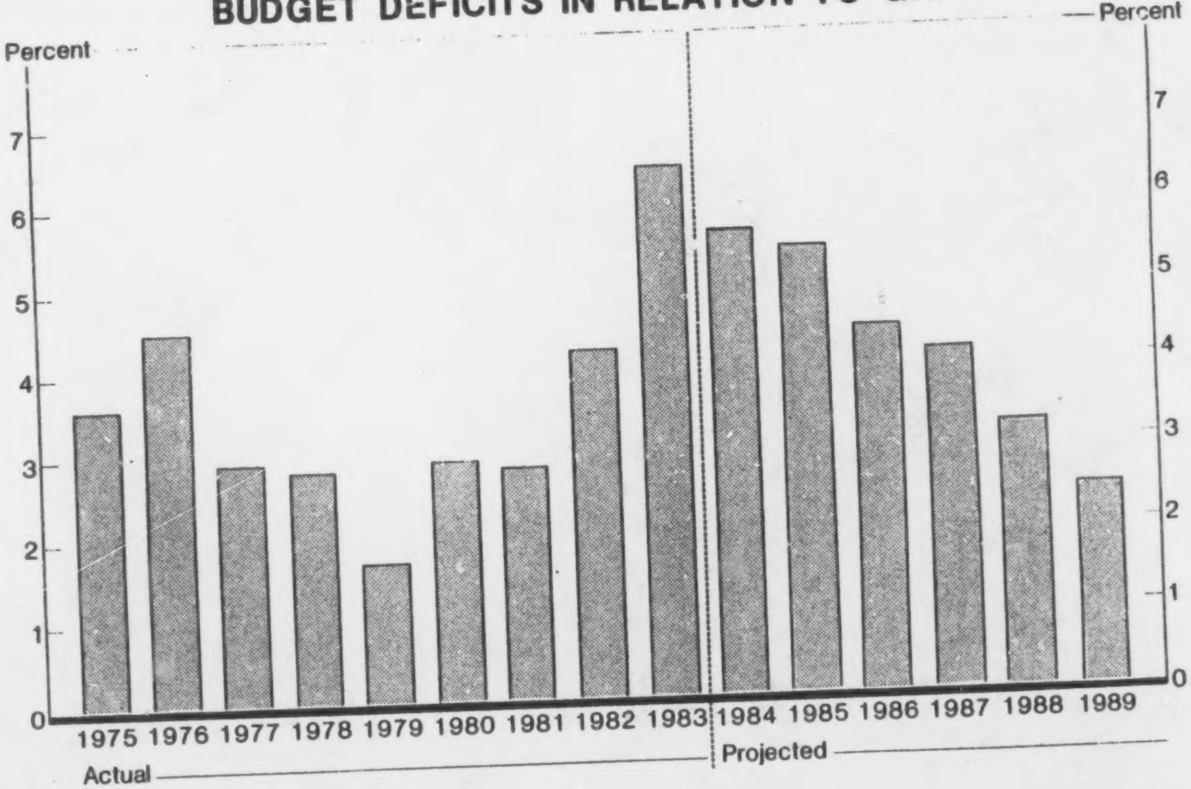
* Including off-budget spending.

Chart 4

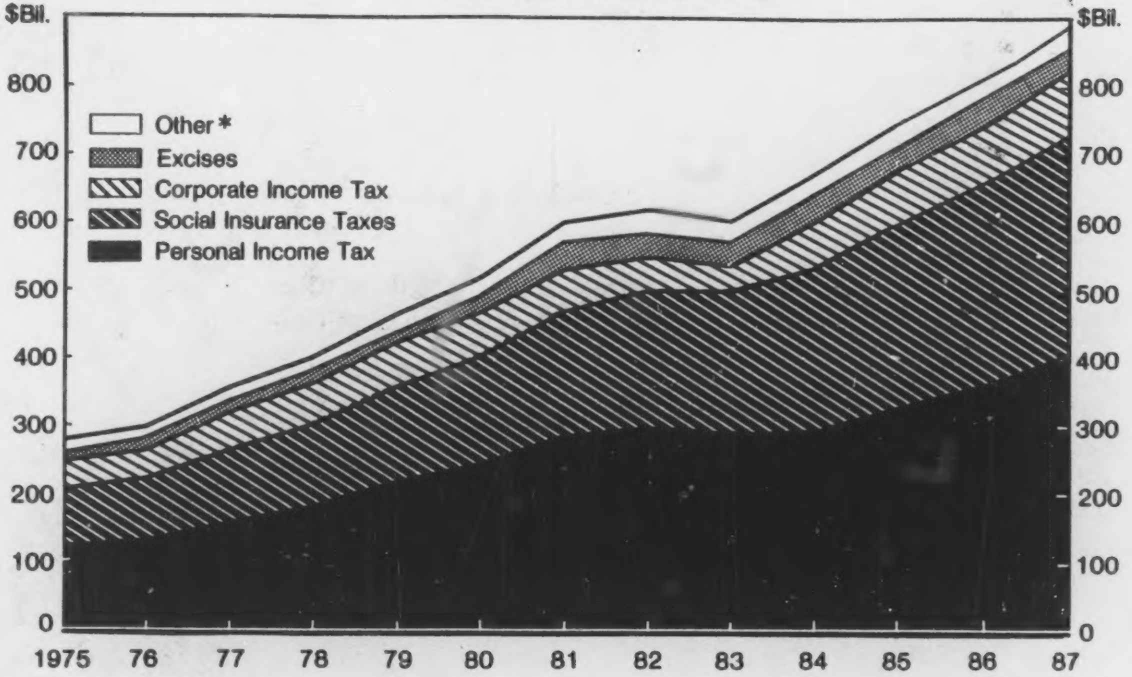
BUDGET DEFICITS IN RELATION TO GNP*



*On and off budget as percent of fiscal year GNP.

Chart 5

BUDGET RECEIPTS



*Other receipts include estate and gift taxes, customs duties, earnings of Federal Reserve System and other miscellaneous receipts.

January 30, 1984-A315

Table 3

SOME KEY COMPARISONS 1980 AND 1983

	1980	1983
Growth in real GNP (in percent)	—0.8	6.1
Growth in civilian employment (millions)	—0.3	4.0
Growth in real wages plus fringes (in percent)	—1.6	2.6*
Rise in consumer prices (in percent)	12.4	3.8
Prime rate of interest (in percent, fourth quarter)	16.7	11.0

*Real compensation per hour.
Four quarters ending in 1983-III.

January 25, 1984 A309

Table 4

RECENT PROGRESS AGAINST INFLATION

(percent change during the year)*

	1979	1980	1981	1982	1983
GNP: Implicit Price Deflator	8.2	10.2	8.7	4.4	4.1
Consumer price index	13.3	12.4	8.9	3.9	3.8
Producer price index	12.8	11.8	7.1	3.7	0.6

* Fourth quarter to fourth quarter for the GNP deflator and December to December for consumer and producer prices.

January 24, 1984-A41

Table 5

COMPENSATION, PRODUCTIVITY AND UNIT LABOR COSTS, NONFARM BUSINESS SECTOR, 1979 - 1983

(percent change from fourth quarter of previous year)

	Nominal Compensation	Real Compensation	Productivity	Unit Labor Costs
1978	8.9	—0.1	0.3	8.6
1979	9.2	—3.2	—2.1	11.6
1980	10.8	—1.6	0.2	10.5
1981	9.0	—0.5	1.2	7.7
1982	7.2	2.6	0.8	6.3
1983*	5.3	2.6	3.6	1.6

* Four quarter change ending in 1983-III

January 24, 1984-A316

Table 6

PATTERN OF GNP GROWTH IN THE FIRST YEAR OF PREVIOUS RECOVERIES* COMPARED WITH 1983

	In Percentage Points		As Proportion of Total	
	Previous Recoveries	1983	Previous Recoveries	1983
Real GNP	6.8	6.1	——	——
Consumer spending	3.6	3.6	53	59
Business capital spending	0.5	1.2	7	20
Residential construction	1.0	1.0	15	16
State and local purchases	0.5	0.1	7	2
Federal purchases	—0.2	—0.5	—3	—8
Inventory investment	1.8	2.0	26	33
Net Exports	—0.4	—1.4	—6	—23

* Post-Korean War recoveries excluding the short-lived 1980 recovery.

Note: Components may not add because of rounding.

January 25, 1984 A311

Table 7

FUNDS RAISED BY DOMESTIC NONFINANCIAL BORROWERS IN U. S. CREDIT MARKETS

(Billions of $)

	1982	1983*
Private Domestic Nonfinancial	234.1	288.1
State and Local Government	36.3	42.7
Households	86.3	149.4
Nonfinancial Business	111.5	96.0
U. S. Government	161.3	205.9
Total	395.4	494.0

FUNDS SUPPLIED TO DOMESTIC NONFINANCIAL BORROWERS IN U. S. CREDIT MARKETS

(Billions of $)

	1982	1983*
Private Financial Intermediaries	271.2	359.8
Commercial Banks	108.5	122.7
Savings Institutions	30.6	129.2
Other	132.1	107.9
Private Domestic Nonfinancial Investors	99.7	97.3
Other	24.5	36.9
Total	395.4	494.0

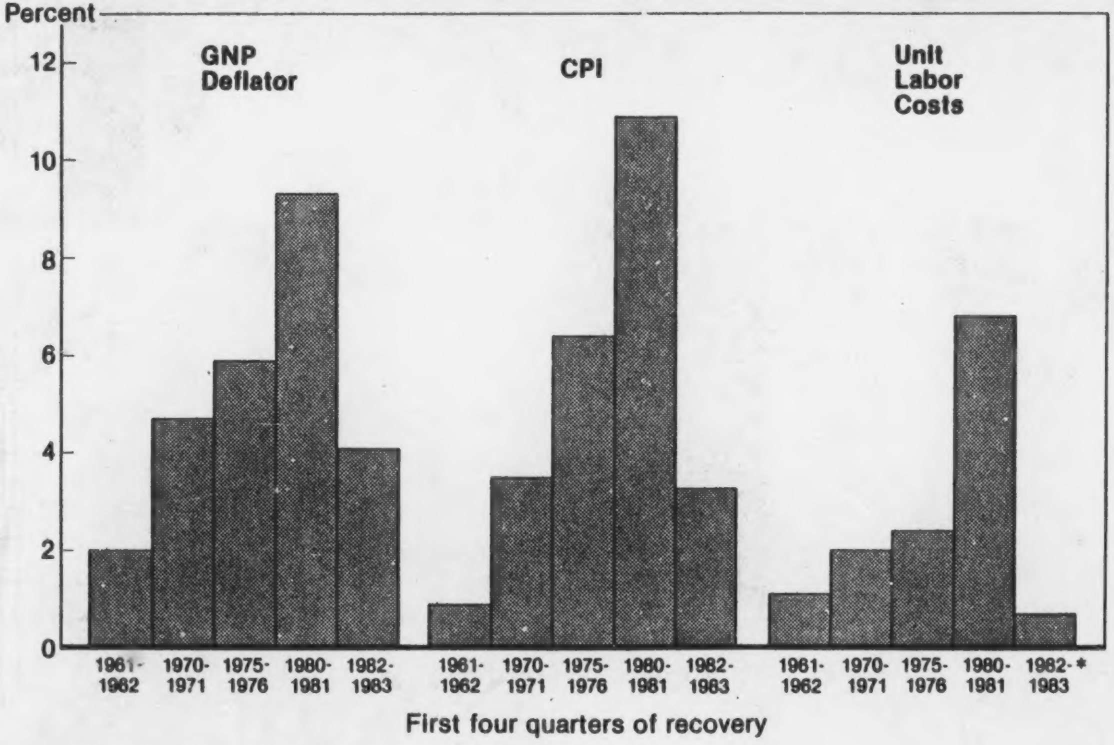
* First 3 quarters at a seasonally adjusted annual rate.

Source: Federal Reserve Flow of Funds

January 24, 1984-A312

Chart 6

GROWTH OF PRICES AND UNIT LABOR COSTS IN THE FIRST YEAR OF RECENT CYCLICAL RECOVERIES



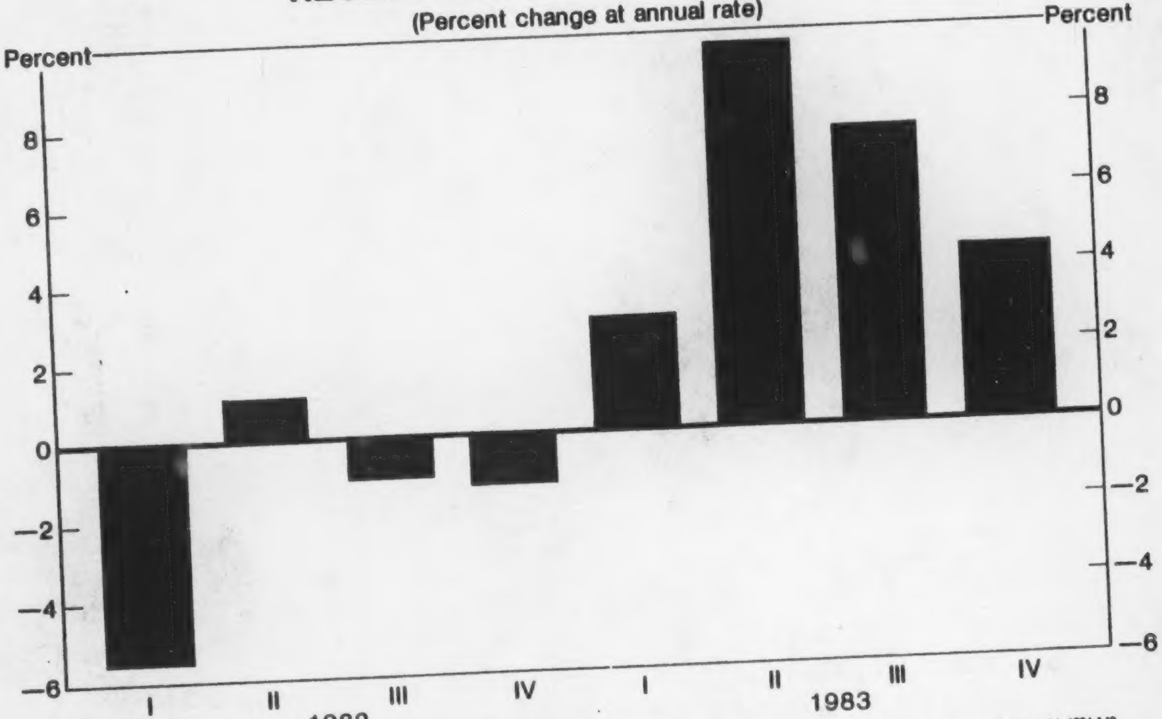
*First three quarters of the cyclical recovery.

January 25, 1984 A308

Chart 7

RECENT CHANGES IN REAL GNP

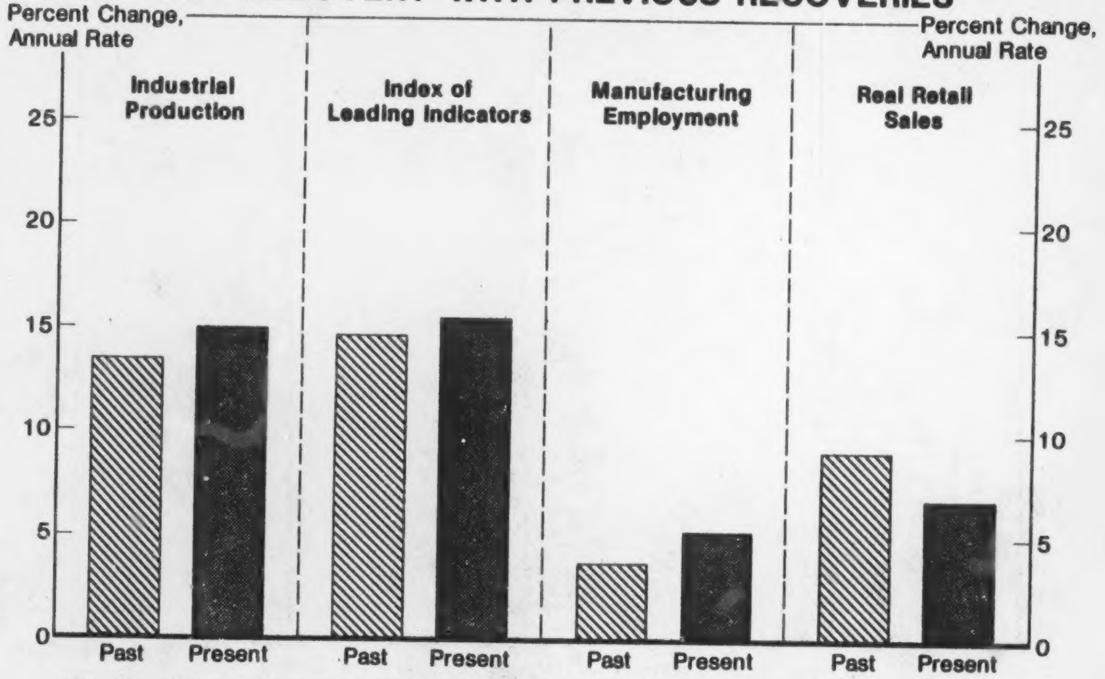
(Percent change at annual rate)



January 11, 1984-A49

Chart 8

COMPARISON OF THIS RECOVERY WITH PREVIOUS RECOVERIES*



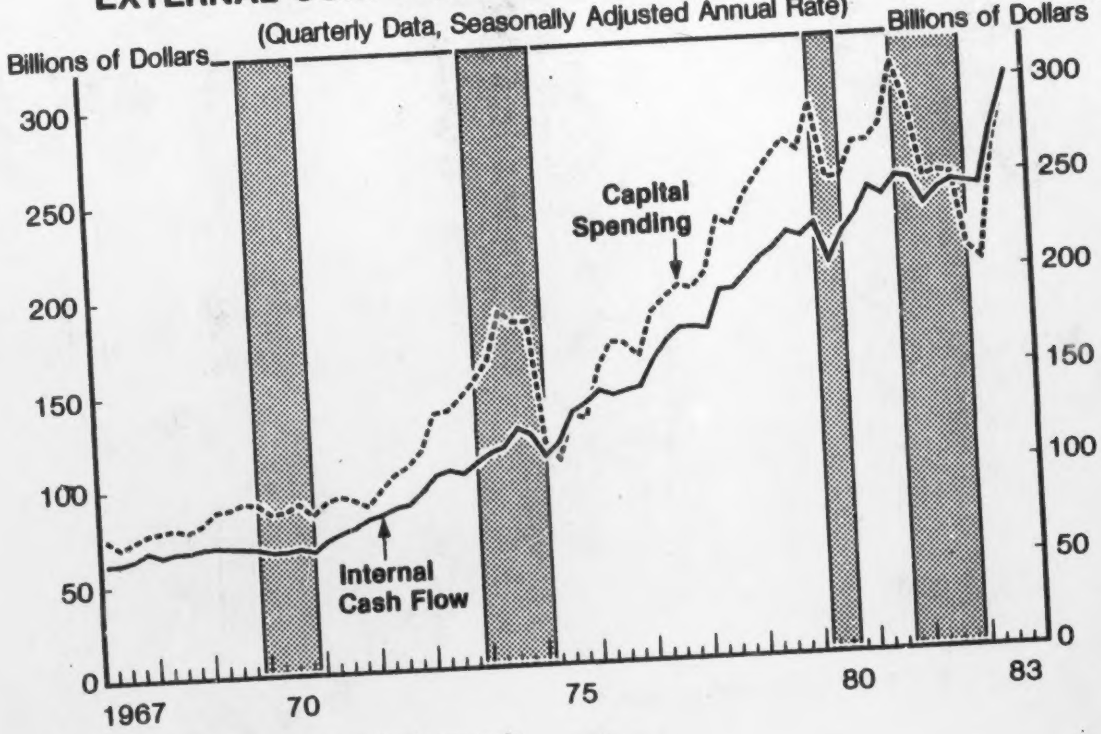
* Post-Korean War recoveries excluding the short-lived 1980 recovery. First 13 months for industrial production and real retail sales, 12 months for the other two series.

February 2, 1984 A44

Chart 9

EXTERNAL CORPORATE FINANCING REQUIREMENTS

(Quarterly Data, Seasonally Adjusted Annual Rate)

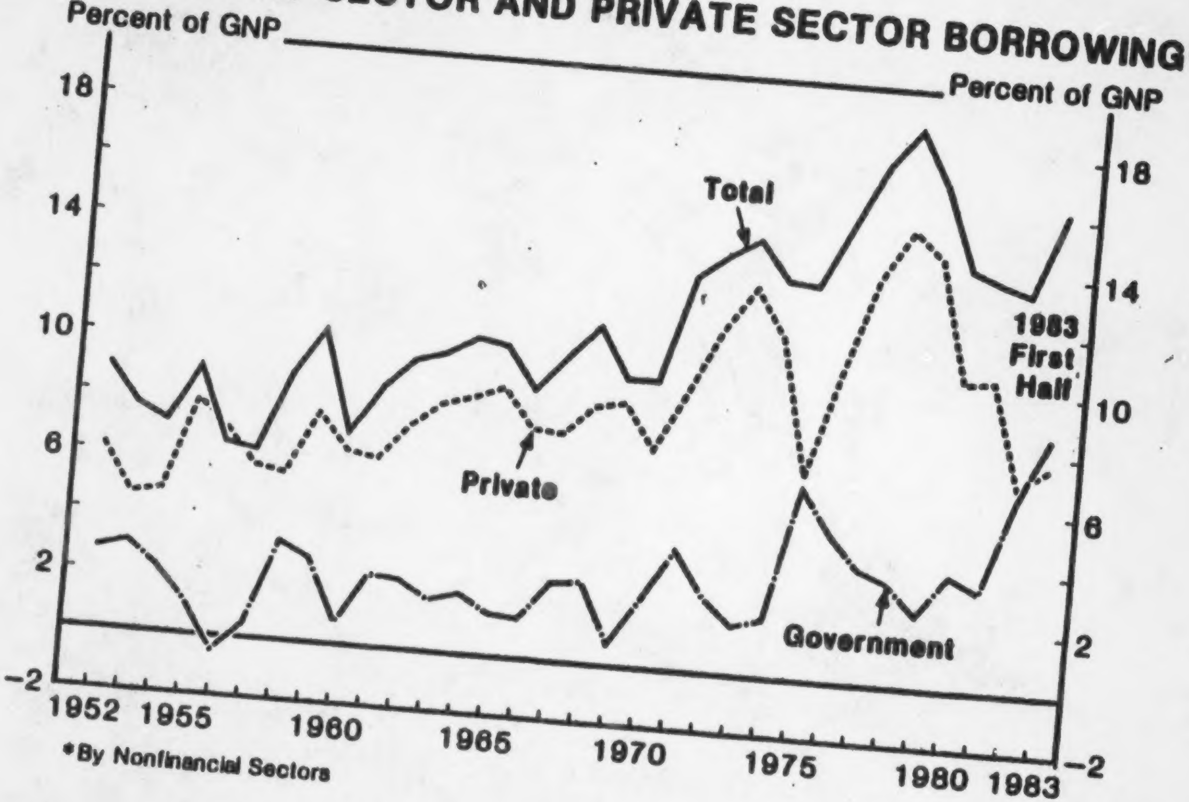


Source: Federal Reserve flow of funds accounts.

February 2, 1984-A84

Chart 10

GOVERNMENT SECTOR AND PRIVATE SECTOR BORROWING*

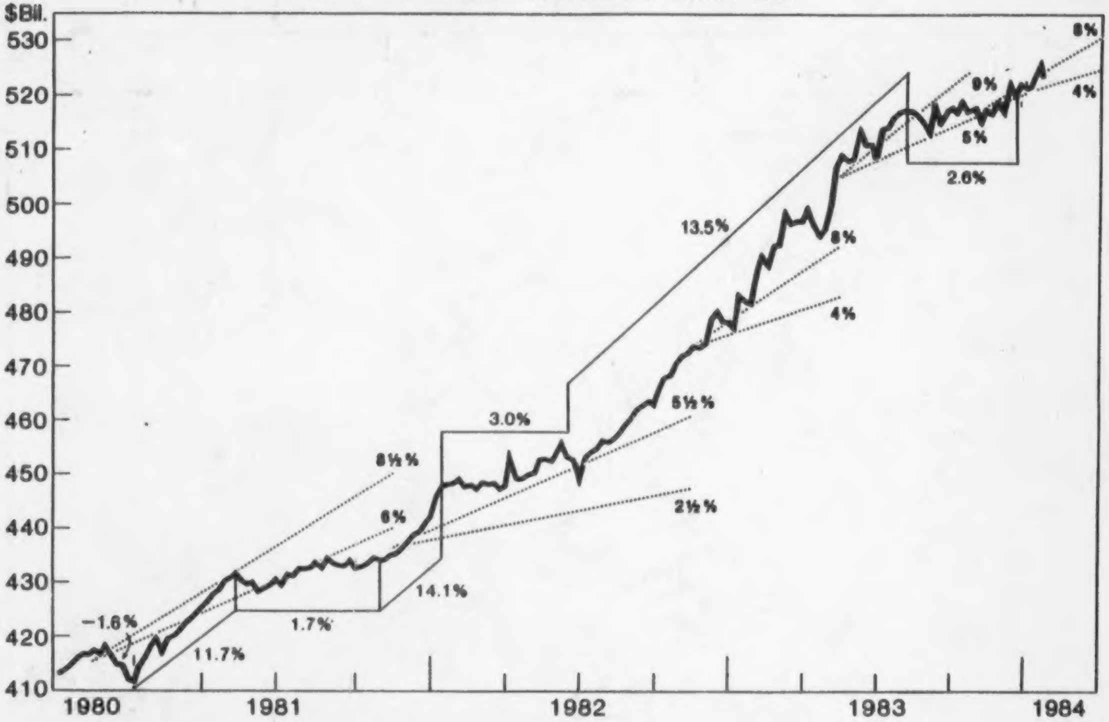


*By Nonfinancial Sectors

October 24, 1983-A244a

Chart 11

M₁ VERSUS TARGET RANGE*



* M₁ data:weekly averages, seasonally adjusted.
Fed target ranges: seasonally adjusted simple annual rates based on quarterly averages.
Period-to-period growth: seasonally adjusted compound annual rates based on monthly averages.
Tentative 1984 M₁ target range (4% - 8%), as announced by the Federal Reserve in July 1983.

January 27, 1984 A350e

FLAT TAX WOULD HAVE TREMENDOUS REPERCUSSIONS

Senator **Kassebaum**. I was interested in your mentioning the importance of simplifying the tax code, and indeed the President spoke to that in his state of the Union speech. It may be the only thing that he and President Carter would agree on, because President Carter also believed that this was important.

I would like to ask—and you mentioned that you would be presenting some alternatives in December 1984—of course, one idea that has been around for a long time is a flat tax rate.

Do you believe this is a fair and viable option? Should there be some degree of progressivity in it at some point?

Secretary **Regan**. Madam Chairman, at this point, I am going to remain neutral on any type of a fairer or simpler tax system until I see the results of some of these studies. I do not think I should start with a prejudiced mind, one way or the other. But however, since you ask a question about a flat tax, let me just make a few remarks about it.

This has the element of simplicity in it, and therefore has a wide popular appeal. But the economic consequences of just a plain, flat tax on all income would have tremendous repercussions.

Example: We know that the entire housing and real estate industry is more or less dependent upon interest income being a deduction from income before taxes. Were we to just have a flat tax, we would have no deductions for interest. What would happen to our building interest with such a proposal? Would it fall flat on its face? Would it continue to be a strong industry? We do not know the answers to some of those questions. We are going to have to try to explore that.

Charities in this country, hospitals, museums, things of that nature, as well as churches, synagogues and the like, if deductions to them are not deductible, what happens to their revenues? Do they drop, and drop alarmingly? We do not know the answers to some of that.

So, a simple flat tax may not be the solution to all our problems. It may create as many as it cures.

So this is one of the reasons that we are going to have to take our time in this study and really think through what the possibilities are.

Then, the other thing is how do we get from here to there. What sort of transition rules are we going to write? Practically every American has some type of financial planning. Corporations have done a lot of financial planning. If we suddenly change the rules of the game, in changing the Tax Code, and do it in a way that breaks sharply with the past, what happens to all of those plans? So we have to be very careful of that.

VALUE-ADDED TAX MUST BE USED CAREFULLY

Senator **Kassebaum**. Value-added tax is an idea, of course, that has been around for some time, and Congressman Ullman was a strong advocate of such. It seems to have lost some of its lustre, and yet, it is mentioned frequently as an alternative.

Senator **Chiles**. He is no longer in the Congress.

Senator **Kassebaum**. Well, I know, and I think it was necessary to point that out. But I did not know, Mr. Secretary, if you would care to comment on that as an alternative.

Secretary **Regan**. Well, I will tell you, most of the other industrialized countries of the Western World have adopted the value-added tax. The main reason that most of them have done it, I find in discussions with their financial ministers and their tax people, is because of tax evasion. At least a value-added tax gets to the so-called tax gap economy, the cash economy. People have to buy things, and if they buy things and are taxed for it, that is one way of getting at it.

However, it is a regressive tax, because it falls mainly on the lower and middle income tax brackets, so you have to be very careful of applying it. And here, I am not being necessarily snide in my remarks about the Congress, but you have to remember that if you start off with a low value-added tax, the temptation would be there to just have it go from, let us say, 3 percent to 4 percent to 5 percent to 6 percent, year on year. So it would be a very tempting target, I am afraid, as far as raising revenue.

ADMINISTRATION FAVORS CONSTITUTIONAL AMENDMENT TO BALANCE THE BUDGET

Senator **Kassebaum**. You mentioned that the President has asked for some tools to enable him to get some control over the budget. I would like to ask your thoughts, for instance, on a constitutional amendment to balance the budget. What if Congress had approved that and the states ratified it in 1981—what type of budget situation would we be seeing today that would be different?

Secretary **Regan**. Had that been ratified in time to have the fiscal 1985 budget come under it, we would be seeing an entirely different budget today. Either we would be seeing more revenues that would have to be voted, that is, tax increases voted by the Congress in an election year, or we would have had to see some massive cuts, because we do have this gap.

But we, seriously, in the administration are for such a balanced budget amendment. We would like to see it brought about. We would like to see the Congress vote for it, the States to pass it, and to have it.

SECRETARY REGAN FAVORS 2-YEAR BUDGET

Senator **Kassebaum**. There are factors that come to play, as you mentioned, the recession and the effect on the budget of the recession. How do you factor in these outside influences, an oil embargo and so forth, that come to play if we have such an amendment? Would it not be a temptation to look at some creative budgeting—for instance, social security will be moving off-budget in 1985?

Secretary **Regan**. That would be a temptation, there is no doubt about it. There would be very much of a temptation to have a capital budget for the Federal Government. Many people have advocated such a thing.

My own guess is that from the point of view of the balanced budget amendment, by and large if it were out there, it is something that the Congress would come to grips with early on and have to plan well ahead. You would have to go probably onto a 2-year budget cycle in order to plan ahead, so as to avoid the repercussions of a recession suddenly coming on unexpectedly.

Senator **KASSEBAUM**. Do you think a 2-year budget cycle would be a good idea?

Secretary **REGAN**. I honestly think it would be. I know that most corporations try to get onto that, and I think on the Federal Government level it would make for better planning. I know in my own Department, Treasury, trying to think ahead in our planning, whether it is for more modern equipment or things of that nature, a 2-year cycle would be very much of an advantage to us.

Senator **KASSEBAUM**. Thank you, Mr. Secretary.

Senator Chiles.

Senator **CHILES**. Thank you, Madam Chairman.

Mr. Secretary, in a lot of areas of economic forecast, we get into theoretical arguments, and we can never pin down who was right and who was wrong. Your prediction, however, of 5 percent Treasury bills by 5 years from now, it seems to me that before long, we could get a clear answer to that. If the money markets believe your prediction, everybody ought to be jumping to buy 7-year Treasury bills, should they not, and that in turn would be forcing those rates down?

How long do you think it would be before people would be going for those 7-year Treasury bills?

5-YEAR PREDICTIONS ARE EXERCISE IN FUTILITY

Secretary **REGAN**. Well, first of all, you have to understand the economic assumptions, how they are arrived at by us or by anyone else who is trying to predict 5 years ahead. That is usually an exercise, Senator, as I have found in 35 years on Wall Street, that is an exercise in futility, to try to predict 5 years ahead and then say, with a degree of certainty what will actually happen.

I think the interest rate projection is more of a guide or a direction, and it is based upon what we feel is apt to happen as a direction, as a guide.

The growth that you referred to in your opening remarks as being without precedent actually did happen in the early sixties, that period from 1962 to 1968——

Senator **CHILES**. Referred to always as the golden age, is it not, or the golden era?

Secretary **REGAN**. Well, I am not sure it was golden, but at least it was better than what we have had in the immediate past.

So that 4-percent average—and all we did, remember——

Senator **CHILES**. What was our deficit during that time, do you recall?

Secretary **REGAN**. According to my chart, they were running around 2 to 3 percent of gross national product, as I recall; the dollar figure, I do not remember, but I think it was 2 to 3 percent of our gross national product.

Senator **CHILES**. I did not think they were ever above 2 percent in that period.

Secretary **REGAN**. In that period—I do not know—in 1968, it was 3 percent, and that is as far back as my chart goes.

Senator CHILES. That during the height of Vietnam.

All right, go ahead.

Secretary REGAN. Be that as it may, what we hope to achieve by our deficit reduction package is to get back to that era, at least in point of view of our figures on the budget.

From the point of view of our assumptions, when we straightlined that 4 percent real growth through 1987, 1988, 1989, what we were trying to indicate is that while there are likely to be years we may be over that, some years we may be below it, 4 percent would be about an average of what we would expect. We know we cannot predict the actual path with any degree of precision. The same thing applies to interest rates. If we do have growth of that nature, if inflation does stay down—as indeed, it has in the past—then we could have T-bill rates coming down. That 5.5 percent is not too high. I can recall in the sixties and early seventies, the T-bill rate being in the 3 to 4 percent area.

Senator CHILES. I can recall when I borrowed money at 4.5 percent interest, but it is getting very dim in my recollection.

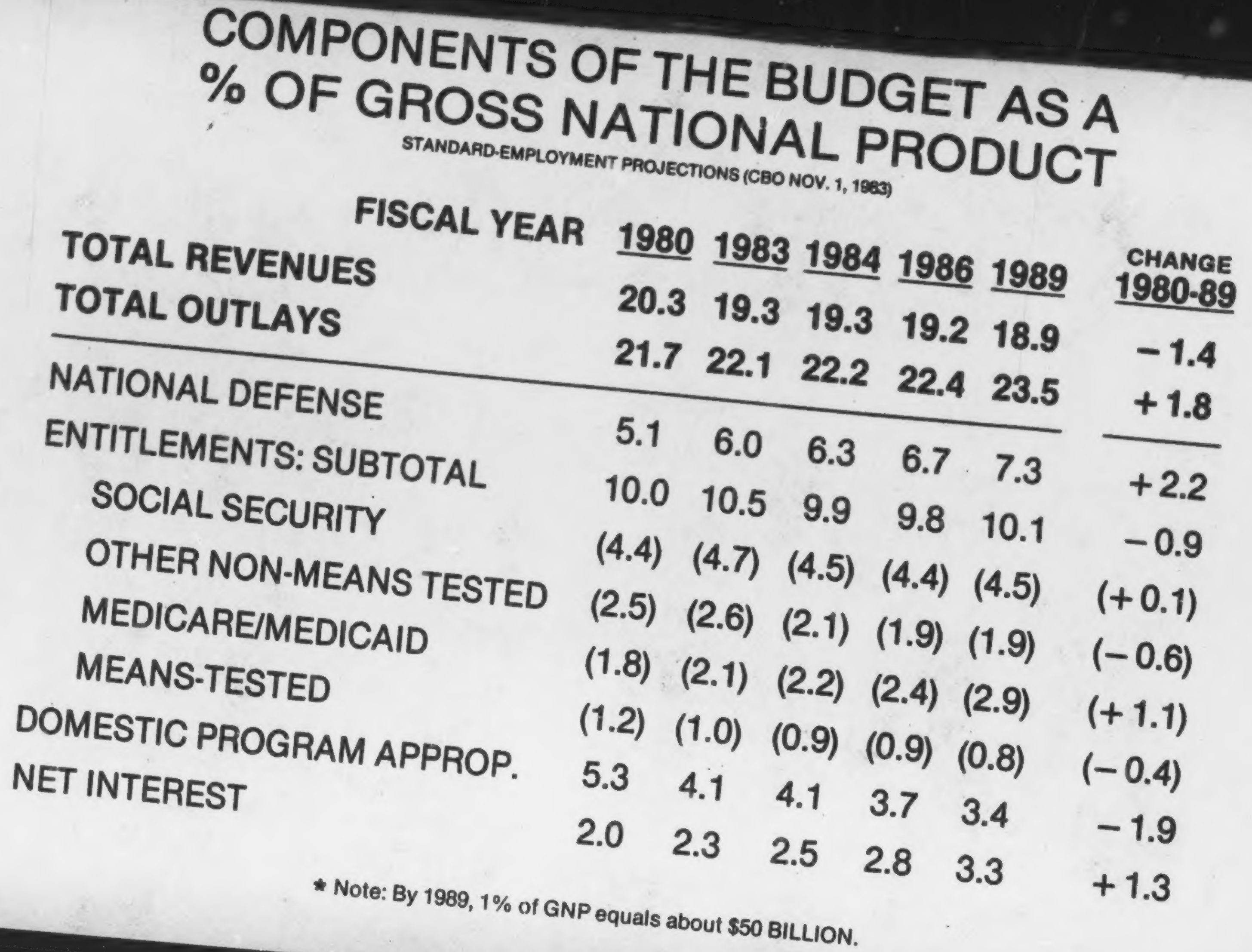
Secretary REGAN. That is true.

SECRETARY REGAN DISAGREES WITH CBO PROJECTIONS

Senator CHILES. Mr. Secretary, the thrust of your testimony seemed to me to be that spending is our problem, and spending is the only way we are going to get out of this. On revenues, you have said "So far and no farther." I assume you are satisfied at the 19 percent GNP level.

After 2 days of testimony I'm beginning to think that if there is going to be a recession anywhere else, it is not going to be in chartmakers. The chartmakers are going to make a fortune, I think. But we have some charts I want you to look at here for a minute.

[The following was received for the record:]



COMPONENTS OF THE BUDGET AS A % OF GROSS NATIONAL PRODUCT

STANDARD-EMPLOYMENT PROJECTIONS (CBO NOV. 1, 1983)

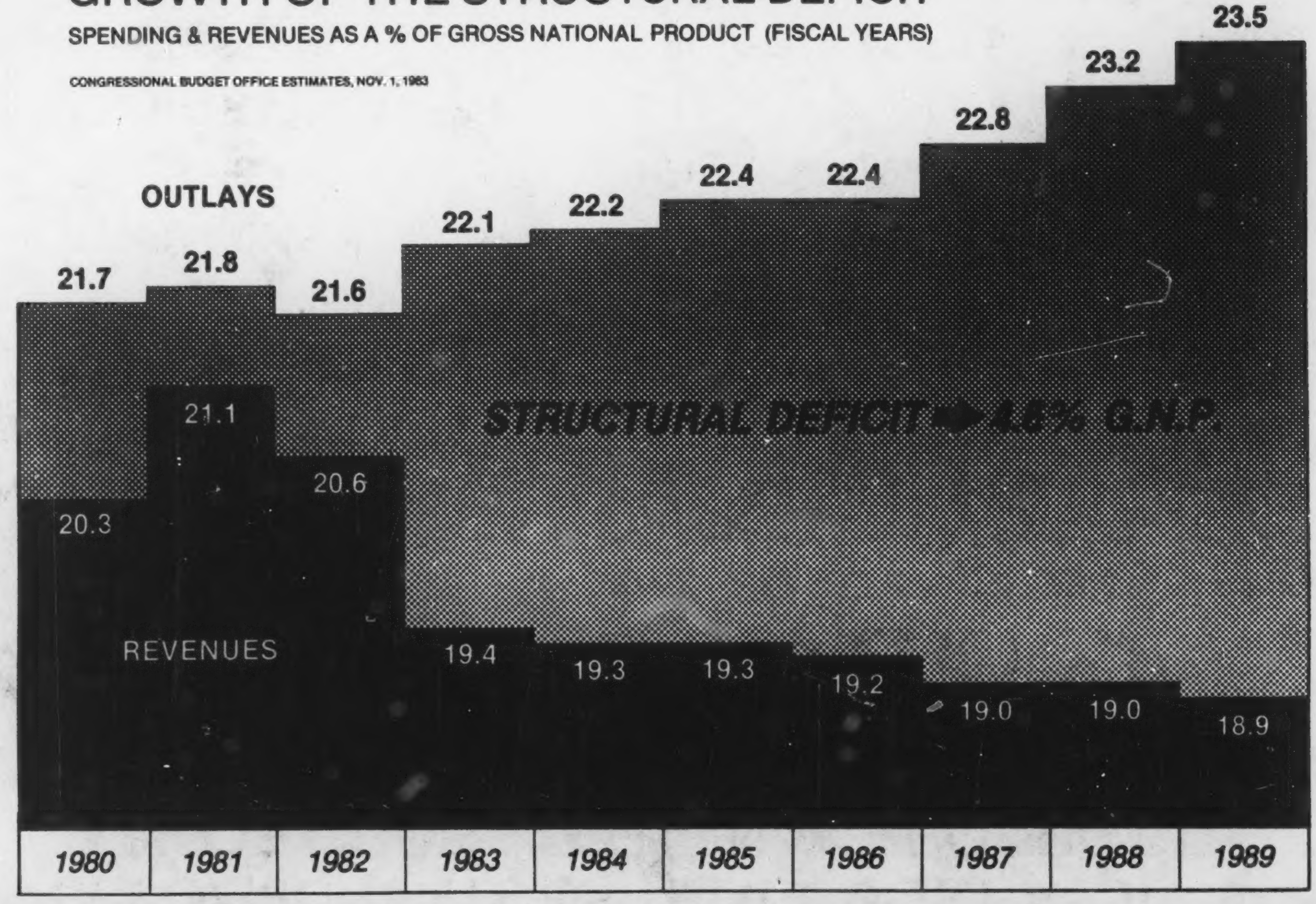
FISCAL YEAR	1980	1983	1984	1986	1989	CHANGE 1980-89
TOTAL REVENUES	20.3	19.3	19.3	19.2	18.9	− 1.4
TOTAL OUTLAYS	21.7	22.1	22.2	22.4	23.5	+ 1.8
NATIONAL DEFENSE	5.1	6.0	6.3	6.7	7.3	+ 2.2
ENTITLEMENTS: SUBTOTAL	10.0	10.5	9.9	9.8	10.1	− 0.9
SOCIAL SECURITY	(4.4)	(4.7)	(4.5)	(4.4)	(4.5)	(+ 0.1)
OTHER NON-MEANS TESTED	(2.5)	(2.6)	(2.1)	(1.9)	(1.9)	(− 0.6)
MEDICARE/MEDICAID	(1.8)	(2.1)	(2.2)	(2.4)	(2.9)	(+ 1.1)
MEANS-TESTED	(1.2)	(1.0)	(0.9)	(0.9)	(0.8)	(− 0.4)
DOMESTIC PROGRAM APPROP.	5.3	4.1	4.1	3.7	3.4	− 1.9
NET INTEREST	2.0	2.3	2.5	2.8	3.3	+ 1.3

* Note: By 1989, 1% of GNP equals about $50 BILLION.

GROWTH OF THE STRUCTURAL DEFICIT

SPENDING & REVENUES AS A % OF GROSS NATIONAL PRODUCT (FISCAL YEARS)

CONGRESSIONAL BUDGET OFFICE ESTIMATES, NOV. 1, 1983



Senator **Chiles**. CBO's chart on "Components of the Budget as a Percentage of Gross National Product," that is a chart that is projecting 6 percent unemployment. And if you look at that chart you see that it starts at 1980 and it goes through 1989. If you look at the elements that CBO is telling us where our problems are in spending, or where our problem areas are, you will see national defense is going to go up 2.2 percent of GNP over that period of time through 1989. Entitlements, as a subtotal, will actually decline nine-tenths of 1 percent, and that is because of what we have done mainly in social security and also in the means-tested entitlement programs, primarily. But entitlements do not appear to be our problem because they are declining a little bit. Domestic program appropriations, other than defense, are actually declining, 1.9 percent of the GNP, so they are not our problem. Net interest is our problem, because it is up 1.3 percent. And our other problem is total revenues again decline 1.4 percent.

So, if spending is our problem, and part of it is in national defense, is this the part of the spending that you want us to slash or to cut?

Secretary **Regan**. Well, not wishing to be quarrelsome, but in all honesty, I do not understand why revenues drop as a percentage of gross national product between 1986 and 1989. They certainly do not under our projections; they go up to 19.8 percent. I do not know what estimates CBO has made that indicate that.

Senator **Chiles**. Well, it is because we are projecting that there is now a structural deficit, and that structural deficit is growing. Your economic projections are not taking into account that you have a structural deficit in the economy.

Secretary **Regan**. Certainly, it takes into account that we have a structural deficit, because it indicates there is still a deficit out there that is not taken care of by full employment. So, I disagree with CBO's projections, and I think that is a question that can only be solved with time as to which set of projections is more nearly correct. But trying to argue with any degree of precision about what will happen out there in 1989, I do not think gets us anywhere.

Senator **Chiles**. Well, all right——

Secretary **Regan**. But stick to 1986 and take a look. You see that 22.4 percent of outlays—that is much higher than the average. In the sixties and seventies, the period just preceding this, Federal spending as a percentage of GNP seldom got above 21 percent. When it hit 21 percent, that was a peace-time high. Now, we just seem to be accustomed to thinking that Federal spending has to remain above 21 percent. I do not agree with that. I think spending can and should be brought down.

GRACE COMMISSION HAS MANY SUGGESTIONS IN DEFENSE AREA

Senator **Chiles**. All right. Where are we going to bring it down? Let us just forget about the differences in our numbers, and let us just talk about the trends. The trends show that national defense is going up, entitlements are coming down, the domestic appropriations are coming down, and so, are you going to cut defense?

Secretary **Regan**. Well, first of all, I do not think entitlements are coming down. We have not made any suggestions for any changes in entitlements. Therefore, as GNP grows, entitlements should be growing right along with it.

As far as defense is concerned, the Grace Commission has made many suggestions in that area. If those are achievable, we certainly will do it.

As far as the other things, the interest payments, that CBO forecast there calls for much higher rate of interest than we project. Who is going to be right on interest rates in 2 years or 3 years? That is a matter of conjecture.

Senator **Chiles**. Well, the President's Economic Report shows us with a structural deficit in 1989 of $197 billion.

Secretary **Regan**. Is that the President's report, or the Chairman of the CEA's report?

Senator **Chiles**. Well, it says, "The Economic Report of the President."

Secretary **Regan**. I am sorry to disagree, Senator, but just read it. That is the President's Economic Report, but it is mainly the report of the Chairman of the CEA. The first six or seven pages are the President's report, and the remainder is the CEA's.

Senator **Chiles**. Don't you think we had better change the flyleaf?

Secretary **Regan**. I do not care about the flyleaf. Just read the rest of the flyleaf.

Senator **Chiles**. It just says, "Economic Report of the President."

Secretary **Regan**. That is exactly what it is, the first eight pages.

Senator **Riegle**. So what do we do—throw the rest away?

Secretary **Regan**. If you wish. As far as I am concerned, you might as well.

Senator **Chiles**. Mr. Secretary——

Secretary **Regan**. As far as I am concerned, you can throw it away.

Senator **Chiles** [continuing]. This is signed by Ronald Reagan. Is that his signature or not?

Secretary **Regan**. That is what I said. Now, the table is not in the part signed by the President. That is what I just told you.

Senator **Chiles**. But you sent this to the Congress, or the President did.

Secretary **Regan**. Fine. Read it. The Economic Report of the President is the first eight pages or so. The remainder is carefully labeled as "The Annual Report of the CEA." And you can have it.

Senator **Chiles**. I really worry about truth-in-labeling now.

Secretary **Regan**. I do not see why, Senator, if you read what I said, it is exactly labeled correctly. You misinterpreted it.

DO NOT INCREASE SPENDING AS REVENUES INCREASE

Senator **Chiles**. Well, I guess we are getting back to how do you propose to get spending down to 19 percent of the GNP.

Secretary **Regan**. I do not. I said that if revenues were to rise to about 19.8 percent of GNP and if we can get outlays to the historical level of somewhere between 20 and 21 percent of GNP, for all intents and purposes the budget will be balanced. The deficit will be less than a half a percent of GNP at that particular moment.

Senator CHILES. How do we get there?

Secretary REGAN. How do we get there? By not increasing spending in accordance with revenues. Revenues are due to increase by around $75 billion. They will increase $70 billion from last year to this year; next year by another $75 billion. Instead of spending all of that, if we hold out and keep our spending levels down; that will take care of the deficit problem.

Senator CHILES. Well, I still have problems with that when I look at the trends that are projected out and see that the areas basically have been capped, except in the defense level. So, is that where you want to hold up?

Secretary REGAN. Well, you are overlooking two things. First of all, in the President's report, what he did say was that he would like a downpayment this year on getting spending down, and that next year he would like major changes to be made. That is what he has called for.

The House of Representatives directed the President to try to do this last year in October, when they passed the reconciliation bill.

There have been many calls for this type of thing—a bipartisan effort to get the deficit down. And that is exactly what we are calling for. The CBO path assumes that there will not be any such action over the 5-year period. I find it incomprehensible that nothing would be done by this Congress.

Senator CHILES. Well, I find it incomprehensible that we can make a simplistic statement that we can do all of that on the spending side and not have to do anything to the revenue side.

Secretary REGAN. Oh, no. You were the one who said "only." I said "primarily"——

Senator CHILES. I thought you said, "So far and no farther."

Secretary REGAN. No, I did not. What I said was—well, read the testimony. It says "primarily in the spending area." We have proposed $72 billion in our budget over the next 3 years in the way of cuts.

Senator CHILES. "We have leveled taxes off as a share of the GNP. We have not destroyed the tax base, as some have charged. We have merely said to Washington and the Congress, 'So far and no farther.'"'

Now, I do not know whether that was in the first three pages, or the eight pages, or what it was, but——

Secretary REGAN. What we have said is that the receipts are going to increase on their own, but that they will remain in the historic area, which is between 19 and 20 percent of our gross national product. We think that is where they should stop, at less than 20 percent of our gross national product—that we should not be taking more revenues, increasing taxes on the American people so that we take more than one-fifth of the entire production of the United States.

Senator CHILES. The last time we had a balanced budget, do you know what our tax structure was, what were our receipts?

Secretary REGAN. I believe 1969 was the last time, and I do not know—we could look that up. From memory, I cannot recall.

Senator **Chiles**. I wonder what it was when we had the balanced budget during the Truman days; what were our tax receipts?

Secretary **Regan**. I have no idea. I could find that for the record. But I would daresay the budget was probably less than one-fifth of what it is now.

Senator **Chiles**. I will try to find that for the record, too, and I will come back to you if I can find it.

Thank you, sir.

[The following was subsequently supplied for the record by the Treasury Department:]

During the Truman Administration, the Federal Budget was in surplus for fiscal years 1947, 1948, 1949, and 1951. The numbers are shown in the following table:

Fiscal Year	Receipts	As Percent of GNP	Outlays	As Percent of GNP	Surplus	As Percent of GNP
		(Dollar figures in billions)				
1947	38.4	17.2%	34.5	15.5%	3.9	1.8%
1948	41.7	16.9	29.8	12.1	12.0	4.9
1949	39.4	15.0	38.8	14.8	0.6	0.2
1951	51.6	16.5	45.5	14.6	6.1	2.0

Ralph B. Bristol, Jr.
566-2797
Feb. 16, 1984

Size of Truman Era Budget Outlays Compared with Current Levels

	Billions of dollars			Billions of 1972 dollars		
Fiscal year	Total	Defense	Other	Total	Defense	Other
1947	34.5	12.8	21.7	88.3	36.5	51.9
1948	29.8	9.1	20.7	67.0	23.0	44.0
1949	38.8	13.2	25.7	85.3	31.9	53.5
1950	42.6	13.7	28.9	93.8	34.5	59.3
1951	45.5	23.6	22.0	97.3	55.5	41.8
1952	67.7	46.1	21.6	134.6	96.4	38.2
1983	796.0	237.6	616.2	354.5	85.9	187.0
1984 proj.	853.8	272.0	653.5	364.4	93.9	183.9

During the four fiscal years prior to the Korean War buildup, 1947 through through 1950, total outlays in real terms were slightly more than one-fifth of the projected FY-1984 level. In nominal terms, outlays in those years averaged about 4 percent of current outlays.

Senator **Kassebaum**. Senator Andrews.

WAITING TO CORRECT DEFICIT WILL MAKE THINGS DIFFICULT

Senator **Andrews**. Thank you, Madam Chairman.

Mr. Secretary, we have talked a lot about charts, and that you can get a chart from almost any kind of chartist, we have proved, I think, in the last few minutes.

Economists, though, one after the other, say that we have to take action now to correct the deficit, or we are going to be in a lot of trouble if we wait.

Do you feel that the reaction will be more detrimental if we wait until after the election to start doing the things that we know have to be done about this deficit?

Secretary **Regan**. It certainly will make things more difficult, Senator, in this respect, that if nothing is done at this particular moment, I would think that the Federal Reserve would find it difficult to have an accommodating money supply that would reduce interest rates. I think interest rates would remain high. That, in turn, would make it much harder on the housing industry and on other sections in the economy. So it would make life a lot more difficult—not impossible, but difficult.

If we do have the downpayment this year and then major action next year, then I think that would mean to the financial markets, to economists, and to others, that there is hope, that things will get better, and that interest rates will come down and the recovery will be prolonged. And I think they would take heart from that.

Senator **Andrews**. But not as much heart as they would take if we did something now to address the problem, instead of really postponing the major part of the action until after the election.

Secretary **Regan**. Well, if we could do something major now, we would agree that that would be the best of all worlds.

Senator **Andrews**. That is right, and the economy and the individual Americans would be far better off if we did something now.

Secretary **Regan**. If we could do it. The only trouble is, as the President said in his report here, recognizing this is a political year, he does not think that we would be able to get very much in the way of a major change in the budget during 1984.

Senator **Andrews**. But Mr. Secretary, if everybody realizes that it would be very advisable to do it now, isn't it incumbent upon the President and the Speaker of the House and others to not hide their heads in the sand and wait until after the election is passed, but get out and provide the leadership to do it now?

Secretary **Regan**. Well, there is to be a meeting of the representatives of the President and the Speaker next Wednesday. It will be interesting to see what will happen; to see whether the two can get together.

We have asked for the $100 billion downpayment. If there is more to be had, and it can be had in a way that can pass this body and the other body, fine by us. But we have to be practical.

MAJOR TAX INCREASES DOUBTFUL

Senator **Andrews**. Well, Mr. Secretary, in being practical, yesterday, Mr. Stockman told us that everything was on the table for discussion, in this bipartisan downpayment group. He told us explicitly that tax increases could be addressed.

Just how far will the administration go in negotiating tax increases? What limits have been set by the White House?

Secretary **Regan**. Well, Senator, you could hardly expect me, in the face of going into negotiations, to put our whole negotiating position on the table for the press, the public, and everybody else to enjoy. That is not the way that negotiations are arrived at.

Senator **Andrews**. And no one understands that better than I do——

Secretary **Regan**. So I am not going to answer your fully on that. In general, though, let me put it this way. Trying to get a major tax change through the Congress in 1984 seems to me to be the height of futility—to assume that you could do such a thing in an election year such as this. Accordingly, I would think that major tax increases are probably something that we could discuss, but I doubt if they would be part of the final bargain that is struck, if any.

Senator **Andrews**. Would indexing be on the table?

Secretary **Regan**. Certainly, we will talk about it, but again, I would say that is one of the things that would never pass this Congress in an election year, and why bother to try it?

Senator **Andrews**. Without, perhaps, the leadership of the President and the Speaker of the House.

Secretary **Regan**. Well, even with their support, I doubt that we are going to find many—a majority—supporting such actions.

Senator **Andrews**. But if, Mr. Secretary, you say it is beneficial for the average American for our overall economy to do it now instead of later, isn't that where leadership comes in?

Secretary **Regan**. It does, but this is also a political leadership, in a political year. And you must take that into consideration, Senator.

Senator **Andrews**. Sometimes, doesn't the political leadership have to take the heat?

Secretary **Regan**. I think we have been taking the heat for the last 3 years.

NO MAJOR CUTS IN ENTITLEMENTS IN 1984

Senator **Andrews**. Mr. Secretary, one other thing about your charts that you had up earlier. You detailed outlays and receipts, and you showed outlays declining from approximately 25 to 22 percent of gross national product over the next several years. With an increase in defense spending and interest payments, which together comprise half of the budget, how are you specifically planning to cut spending in the nondefense and noninterest segments of the budget? Are major entitlement programs going to be on your agenda?

Secretary **Regan**. Not in 1984, Senator. We have not suggested any such thing. We are nibbling on the edges of Medicare. As you know, the Congress tried last year, and we are suggesting again that they slip the COLA's on civilian pensions, military pensions, and veterans' pensions, things of that nature. So as for entitlements, to that extent, we are bringing those proposals forward as methods of cutting spending, but nothing major.

Senator **Andrews**. Not until 1985?

Secretary **Regan**. That is correct.

Senator **Andrews**. Mr. Secretary, your chart on budget receipts shows an even greater percentage of tax revenues in those outyears, coming from personal and social insurance taxes than at the present time.

Can you honestly say that at the present time, personal income taxes are not burdensome, while the corporate tax rate is not at its lowest rate in decades?

Secretary **Regan**. Well, I would suggest that almost any tax is burdensome, as far as most taxpayers are concerned. You have to suggest at what rate is there too steep a graduation. The current rate structure with a maximum of 50 percent with its graduated steps, is probably much too steep a graduation. It is something that, in a simpler and a more fair system of taxes we should attack.

As far as corporate taxes are concerned, there is a school of thought that says that corporations really belong to individuals, and corporation taxes are not the right way to go about it; all taxes should be personal. And we also have a range between that and a body of thought that says, hey, look, corporations must pay at least a minimum tax.

What we tried to do as far as corporate America was concerned was to adjust their depreciation schedules to offset high inflation. We have done that, successfully. As a result, their effective tax rates are declining; corporate taxes as a percentage of total taxes are declining also from what they were in the seventies.

DOWNPAYMENT IS PART OF $106 BILLION PROPOSAL

Senator **Andrews**. Mr. Secretary, one final question to get, again, at my theme of the importance of doing something now instead of postponing it for 12 months.

The administration proposal includes $106 billion in revenue increases and spending cuts. Now, the President has also called for a bipartisan downpayment on the deficit to $100 billion.

How much of the downpayment is already included in the administration's $106-billion proposal, or is the $100 billion in addition to this $106 billion?

Secretary **Regan**. It is hard to answer that one, again, Senator, because I do not know what the outcome of the negotiations will be, what specific items of cuts.

Senator **Andrews**. But what, in the President's mind and in your mind as the chief official of the President—are you looking for this $100 billion to be in excess to the $106 billion, or are you looking——

Secretary **Regan**. No, it is not in excess, Senator. Part of the President's suggestions probably will be adopted by this group, and——

Senator **Andrews**. So, part of the $106 billion is predicated on the success of the $100-billion negotiating figure.

Secretary **Regan**. No, it is not. We could have this budget passed without that group, theoretically, at least. If this committee and the other committees were to adopt this budget as the 1985 budget, we would have this in it.

But in the group discussions, I would suggest that probably half of what will eventually come is already in this budget; the other half to come from items not in it now.

Senator **Andrews**. Thank you.

EFFORTS BEING MADE TO CLOSE TAX LOOPHOLES

Senator **Kassebaum**. Senator Metzenbaum.

Senator **Metzenbaum**. Mr. Secretary, when you have appeared before us in the tax, you told us that if we enacted the President's tax proposal that tax shelters will disappear. And today, you appear before us, and you tell us that the use of tax shelters has been discouraged.

Mr. Secretary, I just think that that is not in accordance with the facts. The Joint Tax Committee says that tax shelters in 1981 were $8 billion, and they are now $11 billion; the public sales of real estate tax shelters in 1980 were $1 billion, and in 1983, they were $4 billion. Private sales of real estate tax shelters totaled between $8 and $20 billion in 1982. Real estate tax shelters have gone up 105 percent in the first three-quarters of 1983. The Wall Street Journal speaks to this. Everybody talks about everybody running for tax shelters. And you come here, after having come here originally and told us to pass the tax bill, and we will eliminate or pretty much cause tax shelters to disappear; now, you tell us that they are being discouraged.

Give me some evidence of that.

Secretary **Regan**. I did not bring any evidence with me, Senator. Let me point this out to you. As you well know as a former businessman, as quickly as the IRS knocks down one tax shelter, tax attorneys, accountants, and the like will come up with others. It is a constant battle between them. That is why we have seen some egregious ones that have happened in the last couple of years, as a result of the 1981 Tax Act and the way it was drafted. Maybe this was unintentional; it probably was unintentional on the part of the Congress and the administration. These are loopholes that we are trying to close as rapidly as we can.

Senator **Metzenbaum**. Do you think it is appropriate for arms of the Government to support tax shelters as a part of Government policy? We know that the Navy and the Air Force were urging the use of tax shelters in connection with the ships and the planes. We know that Mr. Merrifield—look what he has put out. He is the Assistant Secretary of Commerce. Look what Mr. Merrifield put out. He put out all these papers, telling people to do what? Mr. Merrifield says, "The limited partners provide capital for the research and development of the limited partnership in exchange for tax shelters."

I will tell you some others. The DOE came forward and tried to sell the Clinch River breeder reactor on the basis of what kind of tax shelters would be involved.

The weather satellites were proposed to Congress as being a way to sell them, and people would get tax shelters. Synfuels have done the same thing.

My question to you is does this Government have a policy for or against tax shelters, and do you as the Secretary of the Treasury ever move in on another department and say, "Hey, see here. No more tax shelters. That is not the way you sell programs for this Government. That affects the income, that that has an impact upon the budget."

Secretary **REGAN**. Senator, you and I are in general agreement. This is exactly what we are trying to close down, this loophole of "Rent a battleship," or "Rent a City Hall," or "Rent a college," those types of things that are being setup by nontaxpaying units, whether they are Federal, state, or county governments, whether they are not-for-profit organizations or charitable or educational institutions. We are trying to close that door, saying that they cannot, if they are not paying taxes themselves, sell their property and have others get the benefit of ACRS and the ITC.

I agree with you completely on that.

Senator **METZENBAUM**. Then, maybe I can get you to agree on the next point.

Secretary **REGAN**. I am not going to agree in advance. [Laughter.]

Senator **METZENBAUM**. We have a lot of DISC's now. Do you know what DISC's are—they provide for deferred taxation as long as the money is stored overseas.

Secretary **REGAN**. Yes.

FOREIGN SALES CORPORATIONS WILL BE GATT-APPROVED

Senator **METZENBAUM**. Now, we find that GATT does not approve, that there are some problems on that. So now, we find that the Treasury Department, as I understand it, is coming forward to advocate the creation of foreign sales corporations.

Secretary **REGAN**. Right.

Senator **METZENBAUM**. Now, that kind of action on your part has caused Forbes magazine to address itself to say that the administration wants trading partners to like us. To critics, that means forgiving—forgiving—$13 billion in taxes, and to some businessmen, it may mean setting up shop offshore. And Business Week says, "A tax break for exports that hurts the small guy in Kansas," or the small guy around the country.

Now, why are you advocating—these people were supposed to pay their taxes. They were deferred. It is $13 billion. Why is the Treasury Department taking this position?

Secretary **REGAN**. Well, first of all, there is a hearing before the Senate Finance Committee today on that very subject, and Treasury's position will be elaborated on that.

In brief, we recognize that there are many jobs in the United States that are export-related. We know that we have a tremendous trade deficit. We know that tax policy also is shaped in order to promote jobs in the United States. Accordingly, when jobs are export-related, we want to encourage exports.

We know that DISC was condemned by the GATT as being unfair. We have to change. This foreign sales corporation will be

GATT-approved, and it is in line with GATT. It means that this is exactly what our competitors, the other industrialized nations, are doing for their corporations. If we do not help our corporations in competition with German, French, Japanese, corporations in third countries, we will have no exports.

REPATRIATING MONEY OWED WOULD HURT OVERSEAS SALES CORPORATIONS

Senator **METZENBAUM**. But Mr. Secretary, this is not helping them prospectively. They owe us $13 billion, deferred taxes. This does not help them sell one more automobile, one more radio, one more washing machine—nothing. They owe us $13 billion, and we were always promised we would get the money finally.

Now, we find the Treasury coming in and saying, "Well, they owe us, but let them store the money overseas." That does not help the American economy, and it means that we are not going to get $13 billion that they owe us. And I am asking you why you are supporting that position.

Secretary **REGAN**. If you tear down what the exporters have built up, their overseas sales companies, then you will have no exports.

Senator **METZENBAUM**. That would not be hurting their sales. It does not affect their sales——

Secretary **REGAN**. Of course, it would, because if you bring back this money, this is the capital on which they have built these overseas sales corporations. Now, to tell them that they can no longer have those overseas, they must repatriate the money now, is to tell them, "OK, fold up your tents, and come on back. We are not going to do anything more for you." And you know that we have these tremendous deficits now—the trade deficits which everybody says are hurting the United States.

Senator **METZENBAUM**. The future sales could still be made, but the $13 billion that they owe us, they ought to put the money on the table and pay us, and you ought to be there, insisting that they pay us, because you do not need $13 billion sitting overseas in order to help to sell Ford Motor——

Secretary **REGAN**. Are you willing to take the consequences of that action?

TIME NOT RIGHT FOR CUTTING STANDARDIZED BAD DEBT DEDUCTION

Senator **METZENBAUM**. Let me ask you another question. I have been talking with you for several years about the bank bad debt, and each time you have given me a "We will consider." The question that I have is that banks have an artificial bad debt reserve. Prospective costs over 5 years, $4 billion. It is a six-tenths of 1 percent artificial reserve.

No other business in America gets it. Why can't we get the Treasury—I asked you last year for a position, and you said, "We have not come down on a position yet."

I ask you again. Are you prepared to eliminate the standardized bad debt deduction for financial institutions, which last year cost the Federal Treasury $479 million, and which is a special privilege, given only to financial institutions, not given to businesses generally.

Secretary REGAN. I do not think we want to cut it off at this particular moment, Senator. The banks are just now in a recovery from a very dangerous position which resulted from the default and the stretching out of many foreign loans, as well as domestic loans. You know what happened at Penn Square, you know what happened in the Midland Bank situation, you know what happened out on the west coast. If these banks had not had these reserves against which to write off these losses—you saw that Bank of America, one of the largest banks in the world, just took a major writeoff against these reserves—if the banks did not have these reserves at this particular point, we would indeed have a very precarious banking situation.

So I think those reserves have stood us in good fashion during this most recent banking crisis. We are not out of the woods yet. There is still an awful lot of paper around, both domestic and international, that is shaky. And I think if we were to pull the plug on that right now, we might have problems.

Senator METZENBAUM. But you could still have a regular reserve—if it had to be higher, then it would be legitimatized under the IRS. But the question is to have an artificial one, without having any logic to it.

Other businesses have bad debt reserves. Only the banks get an artificial——

Secretary REGAN. Well, we have set this in accordance with the Fed, and the Fed is the one that has to set these reserves aside, working with us. At this particular moment, I have no disposition to want to change what the banks have set aside for bad debt reserves.

Senator METZENBAUM. Will there be a second round, Madam Chairman?

Senator KASSEBAUM. Yes, there will be, if the Secretary has the time to stay.

Senator METZENBAUM. I thank the chairman.

Senator KASSEBAUM. Senator Gorton.

Senator GORTON. Thank you, Madam Chairman.

Mr. Secretary, during the course of your answers to certain questions by Senator Chiles, you rather vehemently disassociated yourself and the President and the administration from most of that report, attributing it to the Chairman of the Council on Economic Advisers.

I would like to ask you whether or not——

Senator CHILES. Is that the title of that? I thought it was the Chairman of the President's Council on Economic Advisers. Is it just a Council, or——

Senator GORTON. I stand corrected, Senator Chiles, but maybe we will be better off letting the Secretary answer these questions.

Is the reason for your——

Senator CHILES. I just wonder if it has any legitimacy at all, or is it totally illegitimate. I mean, is it kind of like a mule—it has no hope for its offspring, and no pride in its parentage.

Senator KASSEBAUM. It is independent, perhaps, I would say, Senator.

NO DIRECT LINKAGE BETWEEN FEDERAL BUDGET DEFICIT AND INTEREST RATES

Senator GORTON. In any event, Mr.Secretary, I wonder whether much of your disagreement with that report stems from its rather explicit set of statements that the high nature of our real interest rate at the present time is attributable rather significantly to the Federal budget deficit, and that a very significant portion of our trade deficit, in turn, is a result of those high interest rates.

Is it still your position that there is no discernible connection between the Federal budget deficit and interest rates?

Secretary REGAN. There is still no evidence that has been shown to us at Treasury that there is a direct linkage. There is an indirect linkage. In many ways, this has been a self-fulfilling prophecy, because of its belief by many people believe in the linkage. But I can show you periods in our economic history when we have had low rates of interest and high deficits, when we have had high rates of interest and low deficits. So the direct linkage is not there.

Senator GORTON. Then, is it your view that interest rates over the course of the next year will be unaffected by whether or not we cut the budget by the $106 billion recommended in that budget document, and/or the $100 billion downpayment to which the President referred last week?

Secretary REGAN. No, that is not my position. I would say that if the downpayment is made and if there is an indication that there will be more deficit reduction next year, people will take heart that the Fed will ease money as a result. The Fed is keeping a tight monetary policy, in my judgment—a tighter monetary policy than it otherwise would have to—because of these deficits. It is afraid of what the deficit might do to the inflation rate of the United States.

Senator GORTON. So at least in that connection and in that respect, there is a connection. If we do not do anything about these deficits, interest rates will be markedly higher than would otherwise be the case.

Secretary REGAN. That is the probability.

DOLLAR NOT OVERVALUED

Senator GORTON. Is another measure of your disagreement with that CEA report your disagreement with its rather precise definition of the overvaluation of the dollar at the present time—do you believe the dollar not to be overvalued in comparison most of——

Secretary REGAN. Yes. I have had 35 years' experience in markets. The Chairman of the CEA has none. And how he arrives at that figure, I would not know. If I had acted on something like that in the marketplace I would be broke at this point, because the dollar has been going up for 3 years, and for 3 years they have been saying it is overvalued. That would mean you would short the dollar in a rising market, and you would go broke shorting in a rising market.

I do not know how they can say that, what with $180 billion daily changing places in the valuation of the dollar vis-a-vis other currencies—that is what the overnight market and the daily market in New York, Chicago, San Francisco, Tokyo, Hong Kong, and all the other markets trade on foreign currency per day. To me it is not acceptable to say that the market is wrong by 32 percent, to judge yourself against all the other marketeers in the country and in the world, with billions of dollars at their disposal, and to say that those people are wrong.

$100 BILLION DEFICIT REDUCTION NOT A CEILING

Senator GORTON. On another subject, Mr. Secretary, you made it rather explicit in a set of earlier answers that the President's $100 billion offer to cooperate with the Congress in coming up with $100 billion over a period of 3 years as a downpayment against these budget deficits was not entirely separate from the $106 billion in deficit reductions included in the budget document itself.

I would like you to develop on that theme to a little bit greater degree. Does that simply mean that what we are negotiating with the President over is simply a modest redistribution among the elements of $106 which you already claim to be included in the budget? Is some of it more—is your goal more deficit reduction than is included in this budget; or is it not? What is the nature of that offer, in other words, insofar as it can impact against the budget deficit?

Secretary REGAN. Well, I think I can best start off with an illustration from my own area, which is revenues, because I am not the authority on the outlay portion of the budget. From the point of view of revenues, we have again suggested capping the health care that is paid by employers to $175 a month for a family plan, $70 for a single plan. We suggested that last year, and it got nowhere. That, I am assured by those on the Finance Committee and the Ways and Means Committee, probably will not go very far this year either. However, there is a possibility that something can be negotiated there.

Now, in this budget we have probably $34 billion of additional revenues over a 3-year period were they all to be put through. If they are not all put through, but a portion is enacted, since we still intend to have some type of alinement between spending cuts and revenue increases in whatever compromise downpayment we come up with, we would have to find additional revenue measures.

Senator GORTON. But at this point, we are just making up for something that we do not do that you have already recommended that we do?

Secretary REGAN. That is what I am suggesting. We would not achieve the $100 billion of cuts or deficit reduction devices we have put into this budget, unless they are adopted in toto on unless other savings can be found.

The $100 billion, by the way, in my judgment, should not be considered as a ceiling, but more as a floor. If more can be done, it should be done.

I would say that probably half of our suggestions might be adopted, and we would have to find at least half, if not more, in other items.

NOTHING ACCOMPLISHED IN ELECTION YEAR

Senator GORTON. Another related question, Mr. Secretary. You made it very clear to Senator Chiles, I believe it was, in his questioning on this deficit, that the limitations which you felt constrained by because this is an election year, that in theory, at least, you would like to do more, but that more cannot be done.

I must say that I am somewhat troubled by that. My own inclination is that the administration and the President might reap political benefits by proposing more than the Congress would do, rather than following it along. But during the course of last year, first, the Congress passed a budget resolution which called for sharper deficit reductions than did the President's budget, and the administration opposed its implementation. Later on in the year, literally up to the last day in which the Congress was in session in 1983, the chairman of the Finance Committee and the chairman of this committee, working together, were attempting to come up with a $150 billion package, evenly divided between spending cuts and revenue increases, to direct at the budget deficits, without any encouragement whatsoever from the administration.

First, are the views which you are expressing here today different from the position which the administration was taking as recently as November and December? And second, is it the thrust of your advice that in an election year, leadership in this respect has got to come from the Congress and not the President?

Secretary REGAN. Well, let me take a crack at that. As far as this being an election year and what we can do under that circumstance, I suppose it is experientia doce. We had an experience with the Congress back in 1981 and 1982 that kind of taught us a lesson. It was called social security. And you will recall that we tried to adjust and change the social security act in 1981 because we felt that the social security trust fund would go broke by 1983 if we did not. That was completely rejected by the Congress——

Senator GORTON. Mr. Secretary, I am going to interrupt on that. You will remember that this committee and this Senate, and for that matter, the House, passed an overwhelmingly reform in the social security system in 1981, a freezing of the COLA's in their largest year, and you and the administration rejected it, before you came up with that. So do not lay an unwillingness to go at that problem in 1981 at the hands of the Congress.

Senator JOHNSTON. It was not a freezing; we reduced it 6 percent from the CPI to the wage index, which is the difference between 14 percent and 8 percent.

Senator GORTON. Senator Johnston is correct.

Secretary REGAN. Continuing on, Senator, in my judgment, that experience showed that in an election year, in 1982, we could accomplish nothing, and we did not accomplish anything. In 1983, however, a nonelection year, and under the lash of necessity of having to do something or else the fund would go broke, we were able to put together a bipartisan commission, a bicameral commission, that successfully did something about social security. Whether the resulting package did all that ought to be done is something only time will tell, but nevertheless, something was done.

In our judgment, 1984 would present similar problems to those in 1982. Very little would be accomplished this year in the way of major changes in the budget in a bipartisan, bicameral fashion. Accordingly, the President made a decision: Let's try for the downpayment this year, and then see if we can make 1985 a repetition of 1983. That is our strategy.

LOOPHOLE CLOSINGS CAN MAKE UP HALF OF DOWNPAYMENT

Incidentally, as far as efforts made last year are concerned, congressional proposals included a large tax increase, which was simply not acceptable to us last year, nor this year. You will recall that half of the proposals made by the chairman of this committee and the chairman of the Finance Committee involved surcharges and large energy taxes.

Senator **Gorton**. Does that mean to say that we are not able to negotiate anything which is as much as half——

Secretary **Regan**. What we have suggested for this year in the way of loophole closings and the like can make up at least half of that downpayment. We do not have to tax the American people with surcharges and energy taxes this year.

Senator **Gorton**. Thank you, Madam Chairman.

Senator **Kassebaum**. Senator Riegle.

Senator **Riegle**. Mr. Secretary, I think it is shocking that you and the President are in here, asking for another $180 billion deficit. And I think the country is finding it very hard to understand what is going on.

In the New York Times today, the lead story, the President is quoted as saying that deficits are, totally unacceptable to me, and yet at exactly the same time, he is in here asking for another $180 billion deficit.

Then, it talks about what David Stockman said here yesterday, where he does not want to cut the deficit by more than $100 billion over 3 years, followed by Martin Feldstein yesterday, saying exactly the reverse, that he wants to cut it by much more than that.

Then, you come in today with the Economic Report, and you tell us that the Economic Report of the President is not really the Economic Report of the President.

Secretary **Regan**. I did not say that, Senator. I object——

Senator **Riegle**. You said the first eight pages——

Secretary **Regan**. Madam Chairman, I object.

Would you please read the record of what I said? I object to the allegation by the Senator that I characterized the Economic Report of the President as being incorrect. I absolutely stated it correctly, and if the gentleman would like, I could read it.

Senator **Riegle**. All right. Let's get it straight.

Secretary **Regan**. Let's get it straight.

Senator **Riegle**. I want your opinion to be factual——

Secretary **Regan**. Would you please withdraw that remark?

Senator **Kassebaum**. Senator Riegle, maybe we can get a copy of exactly what was said at the close of his questioning, and you can proceed ahead now.

Senator **Riegle**. I think that would be helpful. But I want the Secretary to have a chance to put on the record precisely what he thinks.

I want to know what you think. That is what I am interested in hearing. What I thought I heard you say earlier was that the President's position is only the first eight pages here——

Secretary **Regan**. That is correct, Senator.

Senator **Riegle** [continuing]. And the remainder of the document, you are not here to support.

Secretary **Regan**. That is correct, Senator.

Senator **Riegle**. So you, in effect, disavow what comes after the first eight pages; is that correct?

Secretary **Regan**. That is correct, Senator.

Senator **Riegle**. Now, does the President himself also disavow what comes after the first eight pages?

Secretary **Regan**. I have not asked the President.

Senator **Riegle**. But you are here speaking for the President today, aren't you?

Secretary **Regan**. On certain matters but not on that particular mattter, because I have not checked it with him.

Senator **Riegle**. You create an impossible situation. I mean, who are we to believe?

Secretary **Regan**. I have not created it. Someone else created it.

Senator **Riegle**. Well, who would that be?

Secretary **Regan**. I have no idea. I am merely responding to your questions. [Laughter.]

PRESIDENT KNOWS OF DISAGREEMENTS IN HIS ADMINISTRATION

Senator **Riegle**. Well, does the President know that there are such profound disagreements in his own administration?

Secretary **Regan**. He does.

Senator **Riegle**. Well, which side is he on?

Secretary **Regan**. I will refer you to him. I am not——

Senator **Riegle**. Well, he does not come and testify. I have to ask you. You are here representing him.

Secretary **Regan**. I do not know.

Senator **Riegle**. Have you asked the President?

Secretary **Regan**. No; I have not.

Senator **Riegle**. I think it would be useful if you did, because we have got this whole document here, which normally is a very important part of what we use to try to make judgments on your budget request. And if you are saying to us that we ought to discard everything but the first eight pages—this has never happened before. This is really an unprecedented development.

Secretary **Regan**. I have not told you to discard it. I said you could do what you pleased with it.

Senator **Riegle**. Yes, but you have disavowed it yourself.

Secretary **Regan**. As far as I am concerned. What you or the committee wish to do with it is up to you.

Senator **Riegle**. Well, many of us see you as the chief economic spokesman for the President within the Cabinet, so when you disavow it, that carries a good deal of weight.

Secretary **Regan**. That is right.

Senator **Riegle**. Well, I must just say, it seems to me—and I think you can see also the awkwardness of the situation—it appears that the major——

Secretary **Regan**. It is very awkward, not just for you.

Senator **Riegle**. Well, I appreciate your candor, and I think it is important to nail this down, because if everybody is riding off in a different direction here, it is going to be awfully difficult to make some progress and some kind of a positive step this year, rather than finessing this whole problem until after the next election, which I do not think we can afford to do.

Secretary **Regan**. No, I disagree with you on that, Senator. I do not think this will impede the downpayment, or any bicameral, bipartisan type of compromise on reducing the deficit. The problem is still out there, and it has to be addressed regardless of the economic assumptions or economic philosophy.

Senator **Chiles**. I have cleaned mine up. I think maybe you might want to borrow these scissors, Senator Riegle. [Laughter.]

ADMINISTRATION CARRYING ON IRRESPONSIBLE SPENDING BINGE

Senator **Riegle**. Here is the problem, Mr. Secretary, it seems to me. We have found a very important fact yesterday, which I will share with you in just a minute, in terms of the committee hearings here. What that is is that at the present time, and over the last 3 years and the projected fourth year, the administration itself is really carrying on the most irresponsible spending binge that we have seen in our history, and I will document that shortly. And I think these deficits, these massive, continuing deficits, are really a cancer on the American economy.

And the downpayment which is being talked about—which is really an election year device as much as anything—I think is like putting a Band-aid on this cancer.

Now, the fact is that this administration in 4 years' time has actually asked the Congress to spend more money—these are the official requests from the President—as determined yesterday by Senator Domenici and the staff on the majority side of the aisle here in the committee, and presented to Mr. Stockman, which he verified, than we have actually ended up spending. The cold numbers are that the Congress has spent less in total than the President asked for.

Did you know that?

Secretary **Regan**. Not in precise terms, but I——

Senator **Riegle**. Are you surprised to hear that?

Secretary **Regan**. No.

Senator **Riegle**. So, you are not surprised to learn that the President has actually asked to spend more in total—all categories of Government spending—than the Congress has actually agreed to spend. In other words, we have acted to spend less than President Reagan has asked for since the first day he entered office up until today.

You knew that?

Secretary **Regan**. I will not say I knew it. I will say that what has happened is that our requests have been in other areas. You have been spending more——

Senator **Riegle**. I am talking about all areas; I am talking the whole thing—all of your spending requests. The deficit is a function of all spending, not just part of it.

Secretary **Regan**. That is correct. But from the point of view, your spending has been more in some areas than we have wanted.

We have wanted more defense, and you wanted more social spending.

Senator RIEGLE. I understand, within the totals there have been differences of opinion. But you see, I think the American public is under the misimpression that the Congress has spent way in excess of what the President has asked for, and that is not the factual record.

As a matter of fact, you and the President and the others in the administration have come in, and over the period of years, you have asked us officially, with your official budget request, to spend more than we have spent. And I cite that because Government spending as such, when it is less than what you yourself have asked for, can hardly be pointed to as the blame for these massive deficits. Why have you asked us to spend all this money; and why are you asking us now to spend it? You are asking us to go another $180 billion in the hole this year.

I mean, how in conscience can you do that?

Secretary REGAN. Well, we are asking that the $180 billion deficit be reduced, and we would welcome working with you——

Senator RIEGLE. There is not a single proposal on the table—I mean, we just got the budget document 2 days ago. The ink is not even dry, and the President's request is for another $180 billion deficit. If we passed it out of here today without change, exactly the way the President has asked for it, we would have another $180 billion deficit—isn't that the truth?

PART OF DEFICIT DUE TO CYCLICAL CHARACTERISTIC OF A RECESSION

Secretary REGAN. I come back to the point that somebody tried to make with this chart here. Part of this deficit is due to a cyclical characteristic of a recession. Now, you are hardly going to blame us for the recession, are you, when it started in 1979——

Senator RIEGLE. Well, that——

Secretary REGAN. Let me finish my answer, will you, Senator—it started at the end of 1979. There was a slight pause for about 6 months or a year, and we went right back into the same recession.

Most people who have studied it, economists and the like, think that each additional 1 percentage point on the unemployment rate adds $25 to $30 billion to the deficit. As a result of the higher unemployment during that long recession, deficits were widened, representing the cyclical effect.

Now, while I disagree with that chart as to the exact numbers, nonetheless, there is a good point being made there. We have this structural portion of the deficit; that is what we have to deal with.

Senator RIEGLE. My time is up. I just want to put into the record the numbers that Senator Domenici, the chairman of this committee and your party, gave the committee yesterday and which David Stockman verified, and that is that since the Reagan administration has come to office, you have asked the Congress to spend $2.7 trillion. That is the cumulative total of all of the spending requests that the President has made. The Congress has not provided all of that money. We have provided an amount just short of that, close to what he asked for, but less. The Congress has provided $2.7 trillion, but less than the total that the President asked for.

So, lest there be any mistake about it, with the American people thinking that somewhere, there is a villain in this play, whether it be the Congress or somebody else, who has done all of this wild spending, the fact of the matter is that Congress, since President Reagan came to town, has spent less money than the President has asked us to spend—and if, in fact, we had given him every dime he asked for, the deficits would be bigger.

Now, that is the cold fact of the matter.

Secretary REGAN. Well, then, you admit that the Congress is responsible for a great deal of the deficits, along with the President, by your own logic?

Senator RIEGLE. We have spent more than we should, but thank the Lord we did not spend as much as the President asked for, and I hope we will not spend as much as he is asking for this year.

Secretary REGAN. What is the difference between what the President suggested and the figures that Senator Domenici had?

Senator RIEGLE. It is in the range of—it is rounded off here—I would think, hundreds of millions of dollars.

Secretary REGAN. Hundreds of millions. And the deficits that you have just been——

Senator RIEGLE. I beg your pardon. I am told $30 billion.

Secretary REGAN. $30 billion?

Senator RIEGLE. $30 billion.

Secretary REGAN. Well, you have just been talking in terms of about a half a trillion dollars of deficits. So you would admit that the Congress has its hands in at least $450 or $470 billion of deficits.

Senator RIEGLE. Mr. Secretary, there is no question—we have spent almost as much as the President asked for. But the fact of the matter is, the person who has asked for all this big spending is your boss, and that is President Reagan. And the American people have a right to know it.

Senator KASSEBAUM. Senator Symms.

FINANCING THE DEFICIT

Senator SYMMS. Thank you, Madam Chairman.

I have two questions, Mr. Secretary. One of them is based on what has happened with respect to the income tax of 1981, in other words, whose taxes got raised and whose taxes got lowered. But before I get into that, I just want to ask you one question about the financing of the deficit that we do have, which I think is way too high, as we have discussed at other times, and I think that we should be talking in terms of a 10- or 15-percent across-the-board cut. If we spent the same amount of money we did in 1983—$85 million an hour as talked about in here yesterday with Mr. Stockman—that would have a balanced budget for us without raising any taxes. So, it seems to me that $85 million an hour would run probably more government than most people in this country want anyway. But somehow or another, be that as it may, we are spending $100 million an hour.

But what I wanted to ask about is one question about how much of the deficit do you feel, or is it possible for Treasury to be able to tell, is for an investment that is buying our debt.

And if that is the case, down the road, is there some risk involved if something should happen that the American dollar would not be viewed by the market as being as strong an investment, what happens if that money starts leaving the United States? Is that when we really find the problem of financing the deficit?

DOLLAR HAS TO WEAKEN

Secretary **REGAN**. Well, in regard to tracing this foreign capital and as to whether it is actually financing the deficit or not, there is a big argument going on. Tony Solomon, the head of the New York Federal Reserve Bank, made a speech the other day stating that according to the analysis of the New York Federal Reserve and based on the figures he was able to come up with, foreigners are not buying our debt in large amounts, although we do know that there is a lot of foreign money coming in here for investment. Apparently, it is being put into instruments other than U.S. Treasury Securities—real estate, stocks, things of that nature, rather than direct investment in our debt.

As to whether or not that money gets pulled out quickly or not is a matter of conjecture. If one has a real estate investment in Florida or the west coast, or something of that nature, and is a foreigner, that money cannot be pulled out very quickly. One may be able to flee a common stock rather quickly. The chances are, however, that most of that investment is long term, made by institutions abroad rather than individuals who are just in and out, because of the fact that the United States looks like a good area for investment over the next several years. Thus, it is a matter of conjecture as to whether or not this capital would all flee.

There is a fear, and I suspect there is some truth to it, that there is enough froth at the top, so that if people start to flee the dollar, then there might be a mass exit of large proportions, and you would see a precipitous drop. Others say, "No, that could not happen." What the outcome will be, I do not know.

My own judgment is that we will see the dollar weaken. I think the dollar has to weaken. I know of no nation that has continually run trade deficits that has had a strong currency. It should weaken.

CRITICS SUGGEST 1981 TAX RETURN UNFAIR

Senator **SYMMS**. Thank you, Mr. Secretary.

Now, the critics of the 1981 tax return suggest that the rate cuts were unfair and that they benefited the rich at the expense of the lower- and middle-income taxpayers. Now, my question really is, has the tax burden on low- and middle-income taxpayers increased as a result of rate reductions, and did ERTA change the progressivity of the tax system. In other words, from a historical perspective, how is the tax burden being shifted from one group to the other, here—and I would like to have that as part of our record, because we hear about that all the time in this committee, and I would like to hear the Treasury's answer to that.

Secretary **REGAN**. I will submit that for the record. I do know that in the ERTA tax cut, as near as we could determine, it was, in truth, an across-the-board tax cut. For example, the gross income class of $50,000 or less, as a percentage of total tax liability represented 67 percent under prior law, and the across-the-board tax rate reduction for that same group was 69 percent of the total dollar amount from rate reduction, including the reductions of 50 percent in the top rate.

There was symmetry there. I think that what ERTA has done is to slow down the rate of bracket creep, and I think it did make an equitable distribution across all income classes of the tax reduction.

INDEXING WITH RESPECT TO LOW-INCOME PEOPLE

Senator SYMMS. How about the indexing with respect to the low-income people, zero bracket?

Secretary REGAN. As for indexing, that same group that would account for 67 percent of tax liability under the 1980 law— that is those with adjusted gross income of $50,000 and less—they received 69 percent the benefits of rate reductions under ERTA, but will get almost 78 percent of benefits of indexing. In other words, indexing, contrary to most belief, favors the middle and lower classes of income distribution. It definitely favors them over the wealthy.

Senator SYMMS. Thank you very much, Mr. Secretary, and thank you, Madam Chairman.

[The following was subsequently submitted for the record:]

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

DEPUTY ASSISTANT SECRETARY

MAY 16 1984

Dear Senator Symms:

This is in response to your letter of February 7, 1984 regarding the distributional impact of recently enacted tax law changes, indexing, and social security taxes. Please accept my apologies for the delay.

Table 1, enclosed, shows the 1982 level distribution of the major changes in 1984 tax law that were effected by ERTA -- the 23 percent across-the-board tax rate cut, the top marginal rate reduction from 70 percent to 50 percent, and the two-earner couple deduction. The distribution of the 1982 level tax change that will result from indexing, scheduled to begin in 1985, is on Table 2. As shown, these provisions did not significantly alter the distribution of taxes; however, lower income taxpayers received a proportionately larger tax reduction than high income taxpayers.

You also asked for a review of the distributional impact of other tax law changes since 1981. Such an analysis requires income and expenditure data which are not yet within the scope of the Treasury tax model used for estimating the distribution of taxes. However, upon completion of the study of broad-based tax reform, the Treasury will be able to supply this information later this year.

Table 3 shows the current law income tax and social security tax liabilities for four-person, one-earner families at selected income levels for 1981 to 1989. Taxes are computed assuming that incomes increase over time due to projected inflation. Average tax rates represent taxes as a percent of gross income. At lower income levels, the average social security (FICA) tax rate increases over time, a result of the previously scheduled and newly enacted social security tax increases. For the period 1984 to 1989, the average income tax rate remains fairly constant at most income levels. In the absence of indexing, inflation would cause taxes to rise at a faster rate than income, and the average rate would increase. The increase in tax that would result from repeal of indexing is shown for selected income levels on Table 4.

I hope this information is useful to you.

Sincerely,

Ronald A. Pearlman
Deputy Assistant Secretary
(Tax Policy)

The Honorable
Steven D. Symms
United States Senate
Washington, D. C. 20510

Enclosures

TABLE 1

Change in 1984 Law Tax Liability Due to Selected Provisions included in ERTA, Distributed by Adjusted Gross Income Class

(1982 levels of income, 1984 law)

Adjusted gross income class	1984 law tax liability excluding the: i. across-the-board rate reduction, ii. top rate reduction to 50%, and iii. two-earner couple deduction		Change in tax due to the i. across-the-board rate reduction, ii. top rate reduction to 50%, and iii. two-earner couple deduction		1984 law tax liability, current law	
	Amount 1/	Percentage distribution	Amount 1/	Percentage distribution	Amount 1/	Percentage distribution
($000)	($mil.)	(%)	($mil.)	(%)	($mil.)	(%)
Less than 5	$120	*	$-133	-110.8%	$-13	*
5 - 10	6,756	2.1%	-1,806	-26.7	4,950	2.0%
10 - 15	17,201	5.3	-4,072	-23.7	13,129	5.4
15 - 20	23,501	7.3	-5,752	-24.5	17,749	7.3
20 - 30	60,924	18.8	-15,522	-25.5	45,402	18.6
30 - 50	98,106	30.3	-25,461	-26.0	72,645	29.8
50 - 100	59,607	18.4	-14,978	-25.1	44,629	18.3
100 - 200	28,608	8.8	-6,272	-21.9	22,336	9.2
200 or more	28,474	8.8	-5,600	-19.7	22,874	9.4
Total	$323,297	100.0%	$-79,596	-24.6%	$243,701	100.0%

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Note: Details may not add to totals due to rounding.

* Less. than .05%.

1/ Amounts include earned income credit outlay.

TABLE 2

Change in Tax Liability Due to the Indexing Provision Enacted in ERTA, Distributed by Adjusted Gross Income Class

(1982 levels of income, 1984 law)

Adjusted gross income class	Current law tax tax liability, excluding indexing		Change in tax due to the indexing		Current law tax tax liability, including indexing	
	Amount 1/	Percentage distri- bution	Amount 1/	Percentage distri- bution	Amount 1/	Percentage distri- bution
($000)	($mil.)	(%)	($mil.)	(%)	($mil.)	(%)
Less than 5	$-13	*	$-65	2/	$-78	*
5 - 10	4,950	2.0%	-345	-7.0%	4,605	1.9%
10 - 15	13,129	5.4	-497	-3.8	12,632	5.3
15 - 20	17,749	7.3	-584	-3.3	17,165	7.2
20 - 30	45,402	18.6	-1,401	-3.1	44,001	18.6
30 - 50	72,645	29.8	-2,170	-3.0	70,475	29.7
50 - 100	44,629	18.3	-1,125	-2.5	43,504	18.4
100 - 200	22,336	9.2	-344	-1.5	21,992	9.3
200 or more	22,874	9.4	-116	-.5	22,758	9.6
Total	$243,701	100.0%	$-6,647	-2.7%	$237,054	100.0%

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Note: Details may not add to totals due to rounding. Change due to indexing is calculated assuming a 4.2% rate of inflation.

* Less than .05%.

1/ Amounts include earned income credit outlays.
2/ Further reduction from a negative tax amount is meaningless in percentage terms.

TABLE 3
Current Law Income Tax and FICA Tax Liabilities and Average Tax Rates for Four-Person, One Earner Families

(dollars)

			Calendar years								
			1981	1982	1983	1984	1985	1986	1987	1988	1989
$10,000 ($84):	Tax liability:	Income tax.....	37	144	197	290	311	316	326	335	346
		FICA tax.......	579	624	639	670	739	783	816	891	923
		Total tax....	616	768	836	960	1,050	1,099	1,142	1,226	1,269
	Average rate:	Income tax.....	.4%	1.5%	2.1%	2.9%	3.0%	2.9%	2.9%	2.8%	2.8%
		FICA tax.......	6.7%	6.7%	6.7%	6.7%	7.1%	7.2%	7.2%	7.5%	7.5%
		Total tax....	7.1%	8.2%	8.8%	9.6%	10.0%	10.0%	10.0%	10.3%	10.3%
$20,000 ($84):	Tax liability:	Income tax.....	1,596	1,584	1,541	1,549	1,630	1,694	1,762	1,826	1,893
		FICA tax.......	1,157	1,248	1,277	1,340	1,478	1,567	1,632	1,782	1,846
		Total tax....	2,753	2,832	2,818	2,889	3,108	3,261	3,394	3,608	3,739
	Average rate:	Income tax.....	9.2%	8.5%	8.1%	7.7%	7.8%	7.7%	7.7%	7.7%	7.7%
		FICA tax.......	6.6%	6.7%	6.7%	6.7%	7.0%	7.2%	7.2%	7.5%	7.5%
		Total tax....	15.8%	15.2%	14.8%	14.4%	14.8%	14.9%	14.9%	15.2%	15.2%
$30,000 ($84):	Tax liability:	Income tax.....	3,106	3,116	2,968	3,003	3,159	3,286	3,416	3,540	3,665
		FICA tax.......	1,736	1,872	1,916	2,010	2,217	2,350	2,449	2,673	2,769
		Total tax....	4,842	4,988	4,884	5,013	5,376	5,636	5,865	6,213	6,434
	Average rate:	Income tax.....	11.9%	11.2%	10.4%	10.0%	10.0%	10.0%	10.0%	9.9%	9.9%
		FICA tax.......	6.7%	6.7%	6.7%	6.7%	7.0%	7.1%	7.2%	7.5%	7.5%
		Total tax....	18.5%	17.9%	17.1%	16.7%	17.1%	17.1%	17.1%	17.5%	17.4%
$40,000 ($84):	Tax liability:	Income tax.....	5,026	5,048	4,802	4,874	5,127	5,334	5,543	5,743	5,944
		FICA tax.......	1,975	2,171	2,392	2,533	2,771	2,960	3,265	3,522	3,692
		Total tax....	7,001	7,219	7,194	7,407	7,898	8,294	8,808	9,265	9,636
	Average rate:	Income tax.....	14.4%	13.5%	12.6%	12.2%	12.2%	12.2%	12.1%	12.1%	12.1%
		FICA tax.......	5.7%	5.8%	6.3%	6.3%	6.6%	6.8%	7.2%	7.4%	7.5%
		Total tax....	20.1%	19.4%	18.9%	18.5%	18.8%	18.9%	19.3%	19.5%	19.6%
$50,000 ($84):	Tax liability:	Income tax.....	7,324	7,346	7,048	7,165	7,535	7,842	8,149	8,443	8,735
		FICA tax.......	1,975	2,171	2,392	2,533	2,771	2,960	3,325	3,522	3,717
		Total tax....	9,299	9,517	9,440	9,698	10,306	10,802	11,474	11,965	12,452
	Average rate:	Income tax.....	16.8%	15.8%	14.8%	14.3%	14.4%	14.3%	14.3%	14.2%	14.2%
		FICA tax.......	4.5%	4.7%	5.0%	5.1%	5.3%	5.4%	5.8%	5.9%	6.0%
		Total tax....	21.4%	20.4%	19.8%	19.4%	19.7%	19.7%	20.1%	20.2%	20.3%
$100,000 ($84)	Tax liability:	Income tax.....	23,150	23,152	21,920	22,056	23,162	24,152	25,125	26,064	26,973
		FICA tax.......	1,975	2,171	2,392	2,533	2,771	2,960	3,325	3,522	3,717
		Total tax....	25,125	25,323	24,312	24,589	25,933	27,112	28,450	29,586	30,690
	Average rate:	Income tax.....	26.6%	24.9%	23.0%	22.1%	22.1%	22.0%	22.0%	22.0%	21.9%
		FICA tax.......	2.3%	2.3%	2.5%	2.5%	2.6%	2.7%	2.9%	3.0%	3.0%
		Total tax....	28.9%	27.2%	25.5%	24.6%	24.7%	24.7%	24.9%	24.9%	25.0%

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Note: Increases in income are consistent with the economic forecast of the 1985 Budget. Income tax liability is calculated assuming all income is wages and deductible expenses equal 23% of income. FICA tax includes the employees share only.

Table 4

Change in the Income Tax Burden due to the Repeal of Indexing

JOINT RETURN, ONE EARNER, TWO DEPENDENTS

(dollars)

	1984	1985	1986	1987	1988	1989	1984-89
Half of median income							
Current law tax.....	1008	1089	1158	1240	1324	1426	7245
Proposed law tax....	1008	1121	1244	1375	1506	1646	7900
Change	0	32	86	135	182	220	655
Percent change ...	0.0	2.9	7.4	10.9	13.7	15.4	9.0
Median income							
Current law tax.....	3179	3430	3657	3912	4173	4482	22833
Proposed law tax....	3179	3527	3913	4322	4731	5213	24885
Change	0	97	256	410	558	731	2052
Percent change ...	0.0	2.8	7.0	10.5	13.4	16.3	9.0
Twice median income							
Current law tax.....	10305	11134	11895	12743	13598	14564	74239
Proposed law tax....	10305	11480	12654	13897	15140	16605	80081
Change	0	346	759	1154	1542	2041	5842
Percent change ...	0.0	3.1	6.4	9.1	11.3	14.0	7.9
$10,000 ($84)							
Current law tax.....	291	311	316	326	335	346	1925
Proposed law tax....	291	349	406	461	520	580	2607
Change	0	38	90	135	185	234	682
Percent change ...	0.0	12.2	28.5	41.4	55.2	67.6	35.4
$20,000 ($84)							
Current law tax.....	1549	1630	1694	1762	1826	1893	10354
Proposed law tax....	1549	1668	1790	1917	2041	2160	11125
Change	0	38	96	155	215	267	771
Percent change ...	0.0	2.3	5.7	8.8	11.8	14.1	7.4
$30,000 ($84)							
Current law tax.....	3003	3159	3286	3416	3540	3665	20069
Proposed law tax....	3003	3248	3491	3757	4016	4263	21778
Change	0	89	205	341	476	598	1709
Percent change ...	0.0	2.8	6.2	10.0	13.4	16.3	8.5
$40,000 ($84)							
Current law tax.....	4874	5127	5334	5543	5743	5944	32565
Proposed law tax....	4874	5290	5697	6095	6517	6953	35426
Change	0	163	363	552	774	1009	2861
Percent change ...	0.0	3.2	6.8	10.0	13.5	17.0	8.8
$50,000 ($84)							
Current law tax.....	7165	7535	7842	8149	8443	8735	47869
Proposed law tax....	7165	7777	8378	8963	9532	10122	51937
Change	0	242	536	814	1089	1387	4068
Percent change ...	0.0	3.2	6.8	10.0	12.9	15.9	8.5
$100,000 ($84)							
Current law tax.....	22056	23162	24152	25125	26064	26973	147532
Proposed law tax....	22056	23615	25144	26685	28234	29719	155453
Change	0	453	992	1560	2170	2746	7921
Percent change ...	0.0	2.0	4.1	6.2	8.3	10.2	5.4

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Note: The median income of four-person families was $27,619 in 1982 according to advance data from the March, 1983 Current Population Survey. Increases in median income and nominal income are consistent with the economic forecast in the President's Fiscal Year 1985 Budget. Itemized deductions are assumed to be 23 percent of AGI.

Senator **KASSEBAUM**. Senator Exon, I believe you are next.

Senator **EXON**. Thank you, Madam Chairman.

Mr. Secretary, I want to welcome you here——

Secretary **REGAN**. Thank you, Senator.

TRADE DEFICIT

Senator **EXON**. You are welcome as far as I am concerned.

Let me pursue, if I can, the matter of the trade deficit and see where you think that is going to go. I know you have had a lot of experience in that area.

Before we get into that, let me say that while we tend to get into some bickering here, back and forth, I am sure that all of us at this table, and the gentleman sitting there, had better work together to try and solve the tremendously difficult problem that faces us. You do not underestimate for a moment the threat that that deficit holds over the chances of the economic recovery that we would all like to have, do you?

Secretary **REGAN**. By no means, Senator—and by the way, I agree with you on the necessity of our working together. Although in a heated exchange here, it may not look as though I am willing to work with anyone, for the most part, I am willing to work with members of both parties.

From the point of view of this deficit, there is no doubt that if such deficits continue, we are going to run into crowding out. It could happen in 1985, and probably will happen in 1986, if we do not do something about it. By crowding out, I mean that the Federal Government will take a big share of the savings pool, leaving less for business, less for business expansion, so that as a result, businesses cannot obtain credit for expansion.

INTERNATIONAL AGRICULTURAL MARKETPLACE SHRINKS

Senator **EXON**. Let me follow up on a question that was first broached by the Senator from Washington. I hope you know that the agricultural sector of our economy is in deep, deep trouble today, primarily, I think, because we have had such a shrinkage in the international marketplace for both raw and finished agricultural products.

Now, you know that is a fact, and I do. I would like to get at what you think, as a result of your 35 years of experience, is the major reason that we have had such a dramatic downturn of the marketplace that has recently been open to our agricultural producers?

Secretary **REGAN**. First of all, by the way, as an aside, you would not have thought yesterday if you had been in the wheat pit that our farm economy was in trouble as a result of that pesticide; there was some real action in Chicago yesterday.

As a general matter, I think several things have happened to our sales of farm products abroad. First of all, we had the embargo, and that did kill us on the foreign market. It encouraged others to supplant us in the marketplace. Not only Canada, but Australia, Argentina, and Western Europe, all became larger grain producers. Western Europe is a larger grain producer today than 10 years ago. They simply did us out of the grain market, and it made it much more difficult for us to compete with them when we finally dropped the embargo, and it also became more difficult to compete in Third countries.

So, as a result of the larger supplies of wheat or corn or other grains being made available to the rest of the world, the United States now has to try and figure out how it can become more competitive. The high dollar does hurt in that. There is no doubt, if a Third World country has a choice of where to buy grain, if it can buy grain without using dollars, it certainly will, if it can find a better price elsewhere

So, I think that as the dollar drops down, we will be more competitive, and also, we are going to have to figure out how to improve our position in these markets for our people.

HIGH VALUE OF DOLLAR MAIN DETERRENT TO SALES

Senator **EXON**. Then, what you are saying, Mr. Secretary, is that the high value of the dollar, regardless of what happened before, is a main deterrent today to the sale internationally of both agricultural and manufactured products?

Secretary **REGAN**. Well, it is one of the two main things. I think the other main thing is total acreage in the world now that is devoted to grain.

Senator **EXON**. How is the value of the dollar going to come down, with the terribly high deficits that are projected in the President's budget for the years to come? Certainly, there is a relationship, is there not, between high deficits and the high value of the dollar?

Secretary **REGAN**. Well, again, coming back to my favorite theme, the direct linkage has not been made, but no doubt there is definitely a psychological linkage there. And the other way, of course, of getting the dollar down is for other economies to recover. You see, much of what I was talking about in answer to a previous question about foreign capital coming into the United States for investment—the lure of America as a place to invest—will tend to disappear as other economies get stronger. In other words, people will invest in those other nations as readily as they or do here, or at least more readily than they have. That is one way that the dollar can come down, besides getting the deficits down.

PRIME PROJECTED TO GO DOWN

Senator **EXON**. Mr. Secretary, how strongly do you believe that the projection of the prime, measured in T-bills—the figures show basically that within the next 4 years, the prime is going to go down precipitously to almost half of the 9 percent at the present time, to about 5 percent in 1989—how strong do you think that chances are that anything like that is going to happen?

Secretary **REGAN**. I think chances of the bill rate coming down to 5 percent is rather good—if—and this is a big "if"—if we continue to have fiscal discipline, which makes the conduct of monetary policy that much easier.

INDEXING AND OTHER REVENUES

Senator **Exon**. Mr. Secretary, that leads me into my next question. You are quoted in the paper yesterday as saying that,

> The Administration would not accept an across-the-board freeze on spending because some entitlement programs are indexed for inflation, and therefore, could not be touched.
>
> Regan also said that the President objected to tax increases or elimination of indexing of tax brackets for inflation, which is scheduled to begin this year.

So, if we knock out, and if the administration is not interested in touching entitlements and if the administration is not interested in doing anything significant in increasing revenue, those two items foreclose, it seems to me, any real chance of making even a significant downpayment over the next 4 years on reducing the deficit.

How are we going to do that?

Secretary **Regan**. Well, let me make a distinction between indexing and all other revenues. I have not said that we would not consider other revenues. As a matter of fact, I have suggested that we would, in the form of loophole closings and things of that nature. What I said about indexing—and I think I answered this in a previous question—is that it is a very contentious item. I am not certain that a bipartisan group, even if it were to recommend such a thing, could get it through this Congress this year. We believe that this deficit reduction group should work quickly and try to accomplish something upfront before the budget process really gets started through the Congress, and we are afraid it would bog down if it got into such a thing as indexing. We are willing to discuss it, but I think we would have to point out that it is a contentious issue.

But as to loophole closings and the like, I know that the chairman of the Finance Committee has suggested that there are many loopholes that can be closed which would yield a sufficient amount of additional revenue to balance with whatever spending cuts would be suggested.

DIFFERENCES OF OPINION

Senator **Exon**. I guess I am just about out of time, but one last question.

I think we have all been puzzled here today by what appears to be a tremendously sharp difference of opinion between you and Mr. Feldstein. And I think that it makes our job much more difficult in trying to come up with some kind of a rationale, in a bipartisan fashion, to address the problem that we all agree is there.

Don't you agree that under the circumstances, either Mr. Feldstein or yourself, should leave this administration, so that there can be some semblance of coherent economic policy?

Secretary **Regan**. May I tell you something. Based on 10 years' experience as the head of a very large corporation, an experienced chief executive officer welcomes differences of opinion from among his staff. If he has all "yes-men" or only one shade of opinion, he could get the wrong opinion from all of those. He is well-advised to have many shades of opinion expressed. And reasonable men do differ on economics. It is not an exact science; it is far from it. It is almost a nonscience—as well as a dismal science.

But from that point of view, experience in marketplaces teaches one a lot differently than experience in a library teaches one. And accordingly, it is well that both of these opinions are expressed to the chief executive officer of this Nation, so that he can choose between them. And that is his choice.

I would say the same thing to the Congress. You can listen to both shades of opinion. You have to make up your own mind. If you have only one opinion, indeed, there could be a 50-50 chance that it would be the wrong opinion.

Senator **Exon**. So you think you should both stay?

Senator **Kassebaum**. I am sorry, Senator Exon, your time is up.

Secretary **Regan**. That is up to the President, Senator Exon.

Senator **Kassebaum**. Senator Grassley.

TRANSFER OF EXPENDITURES FROM DEFENSE TO NONDEFENSE

Senator **Grassley**. Secretary Regan, I know that you do not have to have a Senator to help you with answers to questions, but I would like to give you one to ponder as a possible answer to the point of view that the budget resolution and where the President was are at about exactly the same place. And I do not find fault with those statistics if they are accurate.

But what we have done here is to transfer from defense to nondefense expenditures, in 1982; $5.4 billion that would have been spent on defense was taken from defense and spent elsewhere. And in 1983, that was $36.2 billion, and in 1984, $80.2 billion.

So, I think it is very legitimate for people to be concerned about the budget deficit, but I think from the standpoint of us in the Congress, that if we are really concerned about the budget deficit—and remember, I am one who suggested a freeze of expenditures—but if we are going to say that the President is spending too much on defense, then we ought to adjust the defense figures, but not then go and spend it someplace else in nondefense, or else we really are not concerned about the deficit. That would be my response to that point of view.

If we are serious about the deficit—and I think that Congress is becoming more serious from year to year—and I do not mean to imply that the President is not serious, because he is, and I know he is serious even though he wants a higher level of defense expenditures than I want—but we have got to go every route we can to save money. So, if we can save it in defense, save it in defense—but not spend it elsewhere.

So, what we have really done here is to just shift from defense to nondefense and then come out at about the same level of total expenditures as what the President has.

So, I would hope that you would argue to people in Congress who are really concerned about the deficit and want to save it, that if they disagree with the President on defense, then cut it out of defense, but not spend it someplace else.

It is that approach that I use. Now, that is not what I wanted to bring up——

Secretary **Regan**. Well, I thank you for the suggestion.

PROJECTIONS OF FUTURE ECONOMIC PERFORMANCE

Senator GRASSLEY. Now, what I want to visit with you about, though, is your projections, as I am trying to get a handle on whether or not we really have good information as we make decisions today that are going to make an impact in future years, because everything we do today, whatever it is, we are making impacts out there for a long time.

Your projections of future performance of the economy are very optimistic. Are you confident in these projections?

Secretary REGAN. Reasonably confident, yes. I will tell you why. Our nearby projections for 1984 and 1985 are in line with mainstream economists. If you take the blue chip forecast of 43 leading economists and econometric organizations, our 4.5 for this year is right in the middle of what all of them are saying and our 4 percent for next year is only a little ahead. There are only a few, and very few, economists who have to go out 5 years. And incidentally, my advice to the Congress would be not to insist on that 5 years, because I think if you go back in history, very few, if any, projections by any administration or any group of predictors has any accuracy. But nevertheless, it is required.

What we have done merely is to straight-line growth or out and to give an indication that we think about 4 percent will be the average over the following several years. We straight lined most of the other as well.

SYSTEMATIC COMPARISON OF 5-YEAR PROJECTION

Senator GRASSLEY. Then, one of your statements brings me to my next question. Have you ever done a systematic comparison of a 5-year projection to make sure how each year came out later on as compared with what was suggested——

Secretary REGAN. No, I have not, but I would be willing to bet you that we have been mostly wrong.

Senator GRASSLEY. OK. Well, I think that is a very candid response. But yet, it is something that you make decisions on and something we make decisions on.

I just wondered if——

Secretary REGAN. Well, could I make a suggestion there, Senator?

Senator GRASSLEY. Yes.

Secretary REGAN. You have got to remember that these are 5-year projections, and like any 5-year projections, they are updated every year, so you can catch yourself before you go too far wrong.

ADMINISTRATION'S RECORD COMPARED WITH 5-YEAR PROJECTIONS

Senator GRASSLEY. OK. Well, I guess I would like to ask you if you could give us some sort of an historical record on this point. Could you provide for me and the committee an analysis of the administration's record in retrospect of having matched up with the 5-year projections—and if you want to go back to past administrations, that would be all right; I do not want to point the finger just at this administration—but I would like to have them in the areas of aggregate revenue and tax expenditures, for items like our

ERTA tax bill, the income we were projecting from that, and TEFRA.

Could you get me that information?

Secretary **Regan**. Oh, yes, I will do that for the record; I am not sure how quickly, but we will do it as quickly as possible. Would you also like it for the CBO?

Senator **Grassley**. Well, we have that, and of course, I am well aware of the inference of your comment, and we are concerned about statistics-gathering by all agencies of Government, as we try to make decisions today, based upon what I believe are inaccurate projections. And yet, you know, we make those decisions, and then we are locked into them. This leads me to believe that we ought to not accept the rosy projections that we have, because I think that we are locked into the bad decisions made on rosy projections.

[The following was subsequently received for the record:]

Accuracy of Longer-Range Economic Assumptions

The attached tables compare administration and CBO longer-range economic assumptions with actual developments. Material covers forecasts made early each year in the years 1977 through 1983. In each instance, actual figures incorporate all data revisions, including the benchmark revisions made each July to national income and product account series.

The material would indicate a general tendency to overestimate real growth and to underestimate unemployment, inflation, and interest rates. For example, in the forecasts made in early 1978, the level of real GNP for the year 1983 was overestimated by 14.7 percent by the (Carter) administration and by 14.1 percent by the CBO. Inflation was underestimated so that nominal GNP (reflecting the combination of real output and price levels) was overestimated in 1983 by only 2.7 percent by the administration and 4.7 percent by CBO. The sensitivity analysis starting on pp. 2-17 of the FY-1985 Budget provides an indication of the impact on deficits of lower than projected real growth and higher than projected inflation. Specifically, slower growth by 1 percent per year accompanied by higher inflation of 1 percent per year for five years starting in 1985 would raise the deficit in FY-1989 by $86 billion, according to the OMB calculation.

Of course, a tendency to overestimate real growth in the past need not mean the current projection of real growth contains the same bias. Indeed, forecasts made early in 1983 for that year erred markedly in the opposite direction.

Errors in forecasting revenues are closely related to errors in the underlying economic assumptions and to policy changes during the forecast period. An analysis of the accuracy of longer-range revenue estimates would yield little information not contained in the measures of accuracy of economic assumptions. (An analysis of the accuracy of revenue estimates one year ahead may be found in A Review of the Accuracy of Treasury Revenue Forecasts, 1963-1978, Congressional Budget Office, February 1981.)

Accuracy of Forecasts of Early 1977*

	1977	1978	1979	1980	1981	1982
Nominal GNP ($bil.)						
Administration	1880	2092	2334	2579	2784	2963
CBO	1884	2085	2304	2547	2809	3103
Actual	1918	2164	2418	2632	2954	3073
Real GNP ($1972, bil.)						
Administration	1331	1398	1480	1562	1623	1680
CBO	1336	1411	1488	1567	1641	1715
Actual	1370	1439	1479	1475	1514	1485
Real GNP growth (%)						
Administration	5.2	5.1	5.9	5.5	3.9	3.5
CBO	5.4	5.6	5.5	5.3	4.7	4.5
Actual	5.5	5.0	2.8	-0.3	2.6	-1.9
Inflation (% ch. in GNP deflator)						
Administration	5.6	5.9	5.4	4.7	3.8	2.8
CBO	5.3	4.8	4.8	5.0	5.3	5.7
Actual	5.8	7.4	8.6	9.2	9.4	6.0
Unemployment rate (%)						
Administration	7.3	6.6	5.7	4.9	4.8	4.7
CBO	6.8	5.9	5.3	4.8	4.4	4.1
Actual	7.1	6.1	5.8	7.1	7.6	9.7
3-mo. Treasury bill rate (%)						
Administration**	4.4	4.4	4.4	4.4	4.4	4.4
CBO	6.2	6.7	6.7	6.7	6.7	6.7
Actual	5.3	7.2	10.0	11.5	14.0	10.7

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* Forecast of Ford Administration as of January 1977 and CBO forecast of December 1976.

** Held at current market rate at time forecast was made.

Note: Actual figures incorporate all revisions to data series.

Accuracy of Forecasts Made in Early 1978

	1977	1978	1979	1980	1981	1982	1983
Nominal GNP ($bil.)							
Administration	1890 p	2099	2335	2587	2858	3133	3400
CBO	1890 p	2107	2334	2582	2854	3156	3465
Actual	1918	2164	2418	2632	2954	3073	3311
Real GNP ($1972, bil.)							
Administration	1337 p	1400	1467	1537	1614	1690	1761
CBO	1338 p	1403	1468	1538	1612	1688	1751
Actual	1370	1439	1479	1475	1514	1485	1535
Real GNP growth (%)							
Administration	4.9 p	4.7	4.8	4.8	5.0	4.7	4.2
CBO	4.9 p	4.8	4.7	4.8	4.8	4.7	3.7
Actual	5.5	5.0	2.8	-0.3	2.6	-1.9	3.3
Inflation (% ch - GNP deflator)							
Administration	5.6 p	6.1	6.2	5.7	5.2	4.7	4.2
CBO	5.6 p	6.3	5.9	5.6	5.5	5.6	5.8
Actual	5.8	7.4	8.6	9.2	9.4	6.0	4.2
Unemployment rate (%)							
Administration	7.0	6.3	5.9	5.4	5.0	4.5	4.1
CBO	7.0	6.5	6.2	5.7	5.2	4.7	4.5
Actual	7.1	6.1	5.8	7.1	7.6	9.7	9.6
3-mo. Treas. bill rate (%)							
Administration	5.2	6.1	6.1	6.1	6.1	5.8	5.3
CBO	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Actual	5.3	7.2	10.0	11.5	14.0	10.7	8.6

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p - Preliminary actual number for the year.

Note: Actual figures incorporate all revisions to the National Income and Product Accounts.

Accuracy of Forecasts Made in Early 1979

	1978	1979	1980	1981	1982	1983
Nominal GNP ($bil.)						
Administration	2106 p	2343	2565	2825	3090	3336
CBO	2107 p	2351	2595	2894	3229	3595
Actual	2164	2418	2632	2954	3073	3311
Real GNP ($1972, bil.)						
Administration	1384 p	1430	1466	1528	1599	1669
CBO	1385 p	1428	1463	1525	1594	1667
Actual	1439	1479	1475	1514	1485	1535
Real GNP growth (%)						
Administration	3.9 p	3.3	2.5	4.2	4.7	4.4
CBO	3.9 p	3.1	2.4	4.3	4.5	4.5
Actual	5.0	2.8	-0.3	2.6	-1.9	3.3
Inflation (% ch - GNP deflator)						
Administration	7.4 p	7.7	6.8	5.7	4.5	3.4
CBO	7.5 p	8.2	7.7	7.0	6.7	6.5
Actual	7.4	8.6	9.2	9.4	6.0	4.2
Unemployment rate (%)						
Administration	6.0	6.0	6.2	5.7	4.9	4.2
CBO	6.0	6.2	6.8	6.6	6.2	5.9
Actual	6.1	5.8	7.1	7.6	9.7	9.6
3-mo. Treas. bill rate (%)						
Administration	7.2	8.8	7.6	6.6	5.4	4.4
CBO	7.2	9.1	7.6	7.8	7.7	7.5
Actual	7.2	10.0	11.5	14.0	10.7	8.6

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p - Preliminary actual number for the year.

Note: Actual figures incorporate all revisions to data series.

Accuracy of Forecasts Made in Early 1980

	1979	1980	1981	1982	1983
Nominal GNP ($bil.)					
Administration	2369 p	2567	2842	3206	3619
CBO	2369 p	2555	2849	3210	3611
Actual	2418	2632	2954	3073	3309
Real GNP ($1972, bil.)					
Administration	1431 p	1423	1448	1510	1586
CBO	1431 p	1418	1446	1495	1552
Actual	1479	1475	1514	1485	1535
Real GNP growth (%)					
Administration	2.3 p	-0.6	1.7	4.3	5.0
CBO	2.3 p	-0.9	2.0	3.4	3.8
Actual	2.8	-0.3	2.6	-1.9	3.3
Inflation (% ch - GNP deflator)					
Administration	8.9 p	8.9	8.8	8.2	7.4
CBO	8.8 p	8.8	9.3	9.0	8.4
Actual	8.6	9.2	9.4	6.0	4.2
Unemployment rate (%)					
Administration	5.8	7.0	7.4	6.8	5.9
CBO	5.8	7.0	8.0	7.7	7.1
Actual	5.8	7.1	7.6	9.7	9.6
3-mo. Treas. bill rate (%)					
Administration	10.0	10.5	9.0	8.4	7.7
CBO	10.1	10.1	8.9	8.7	8.0
Actual	10.0	11.5	14.0	10.7	8.6

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p - Preliminary actual number for the year.

Note: Actual figures incorporate all revisions to data series.

Accuracy of Forecasts Made in Early 1981 by the Carter Administration and CBO

	1980	1981	1982	1983
Nominal GNP ($bil.)				
Administration	2627 p	2928	3312	3718
CBO	n.a.	n.a.	n.a.	n.a.
Actual	2632	2954	3073	3311
Real GNP ($1972, bil.)				
Administration	1481 p	1493	1545	1600
CBO	n.a.	n.a.	n.a.	n.a.
Actual	1475	1514	1485	1535
Real GNP growth (%)				
Administration	-0.1 p	0.9	3.5	3.5
CBO	n.a.	1.4	2.9	2.9
Actual	-0.3	2.6	-1.9	3.3
Inflation (% ch - GNP deflator)				
Administration	9.0 p	10.5	9.3	8.5
CBO	n.a.	10.3	9.2	8.6
Actual	9.2	9.4	6.0	4.2
Unemployment rate (%)				
Administration	7.2	7.8	7.5	7.1
CBO	n.a.	7.7	7.6	7.5
Actual	7.1	7.6	9.7	9.6
3-mo. Treas. bill rate (%)				
Administration	11.5	13.5	11.0	9.4
CBO	n.a.	12.7	13.8	11.6
Actual	11.5	14.0	10.7	8.6

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p - Preliminary actual number for the year.
Note: Actual figures incorporate all revisions to data series.

Accuracy of Forecasts Made in Early 1981 by the Reagan Administration and CBO*

	1980	1981	1982	1983
Nominal GNP ($bil.)				
Administration	2629 p	2920	3293	3700
CBO	n.a.	n.a.	n.a.	n.a.
Actual	2632	2954	3073	3311
Real GNP ($1972, bil.)				
Administration	1482 p	1497	1560	1638
CBO	n.a.	n.a.	n.a.	n.a.
Actual	1475	1514	1485	1535
Real GNP growth (%)				
Administration	-0.1 p	1.1	4.2	5.0
CBO	n.a.	1.3	2.5	2.7
Actual	-0.3	2.6	-1.9	3.3
Inflation (% ch - GNP deflator)				
Administration	9.0	9.9	8.3	7.0
CBO	n.a.	10.3	9.2	8.6
Actual	9.2	9.4	6.0	4.2
Unemployment rate (%)				
Administration	7.2	7.8	7.2	6.6
CBO	n.a.	7.8	7.9	7.8
Actual	7.1	7.6	9.7	9.6
3-mo. Treas. bill rate (%)				
Administration	11.5	11.1	8.9	7.8
CBO	n.a.	12.6	13.7	11.5
Actual	11.5	14.0	10.7	8.6

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p - Preliminary actual number for the year.
* - CBO alternative using Reagan budget numbers.
Note: Actual figures incorporate all revisions to data series.

Accuracy of Forecasts Made in Early 1982

	1981	1982	1983
Nominal GNP ($bil.)			
Administration	2922 p	3160	3524
CBO	2922 p	3140	3515
Actual	2954	3073	3311
Real GNP ($1972, bil.)			
Administration	1510 p	1513	1591
CBO	n.a.	n.a.	n.a.
Actual	1514	1485	1535
Real GNP growth (%)			
Administration	2.0 p	0.2	5.2
CBO	1.9 p	-0.1	4.4
Actual	2.6	-1.9	3.3
Inflation (% ch - GNP deflator)			
Administration	9.1 p	7.9	6.0
CBO	9.1 p	7.5	7.3
Actual	9.4	6.0	4.2
Unemployment rate (%)			
Administration	7.6	8.9	7.9
CBO	7.6	8.9	8.0
Actual	7.6	9.7	9.6
3-mo. Treas. bill rate (%)			
Administration	14.1	11.7	10.5
CBO	14.0	12.0	13.2
Actual	14.0	10.7	8.6

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p - Preliminary actual number for the year.

Note: Actual figures incorporate all revisions to data series.

Accuracy of Forecasts Made in Early 1983

	1982	1983
Nominal GNP ($bil.)		
Administration	3058 p	3262
CBO	n.a.	3266
Actual	3073	3311
Real GNP ($1972, bil.)		
Administration	1476 p	1496
CBO	1476 p	n.a.
Actual	1485	1535
Real GNP growth (%)		
Administration	-1.8 p	1.4
CBO	-1.8 p	2.1
Actual	-1.9	3.3
Inflation (% ch - GNP deflator)		
Administration	6.0 p	5.2
CBO	n.a.	4.6
Actual	6.0	4.2
Unemployment rate (%)		
Administration	9.7	10.9
CBO	9.7	10.6
Actual	9.7	9.6
3-mo. Treas. bill rate (%)		
Administration	13.0	10.2
CBO	10.6	6.8
Actual	10.7	8.6

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p - Preliminary actual number for the year.

Note: Actual figures incorporate all revisions to data series.

Senator **Grassley**. Madam Chairman, that completes my questions.

Thank you very much, Mr. Secretary.

[Whereupon, Senator Domenici assumed the chair.]

Chairman **Domenici**. Mr. Secretary, I think Senator Kassebaum has apologized for my absence. I appreciate your being here this morning. I am sure you had plenty of demands of your time.

Secretary **Regan**. You could stop after the word, "demands." I have had plenty of demands this morning.

Chairman **Domenici**. Well, you will work some of those out, I am sure.

Senator Biden is next.

FLAT TAX

Senator **Biden**. Mr. Secretary, without plowing over a lot of ground that probably would be worth going into, but has already been mentioned, let me go back to a comment you made which I understand there have been no questions asked about—and I apologize for being in and out. I had a meeting with Senator Baker, and that is why I had to leave and come back. He wanted to know what kind of job the chairman was doing and I told him very well.

The flat tax. I understand Senator Kassebaum asked you a question about the flat tax, and the staff note I received is that your comment was something to the effect that the flat tax had some problems, and you pointed out at least a couple of those potential problems. One was the dependency of the real estate industry on mortgage interest deductions, and then the charitable deduction, and probably others.

TIME FOR A TRUCE

Yesterday, when your counterpart from OMB was up here, I suggested—and I was not being facetious—that it is time to declare a truce because of several things that you said today and that the President has said in the last couple of days.

You indicated, probably not for the first time, but for the first time recently that I have heard—and I am sure you have said it to other people in other places—that if we do not do something about the deficits that the crowding out we have all been talking about will begin in 1985. And we all know what the effects of that are likely to be. We do not know exactly what they will be, but they are not going to be good.

So, it seems as though we are coming to a point where—and probably the hardest thing in the world to do, and it may reflect the fact that, even after 11 years here, I am still a little too naive—but in an election year, to try to go off in a back room and lay aside some of our deep political differences—and they are deep—and not argue about how we got to where we are.

So, trying to piece together what I read between the lines—and again, maybe I am being too optimistic—is the willingness of the administration to try to work out some of these serious problems, and the reason for not coming more boldly forward now is that it is an election year, and the justified concern, in my view, that we Democrats might take some of those suggestions which may be justified and real, and could be worked out in a back room, but if they are floated by you first, we beat up on you, and if they are floated by us first, you Republicans beat up on us. So the only way we are going to do it is someplace other than in this room.

But I want to throw into the mix this notion, that I think it is time for a truce, and I think that the flags are out on both sides, saying, "Let's meet." And that process, we are keeping our fingers crossed, is beginning, and hopefully, will produce something.

We have thus far, though, among the Democrats and among the Republicans I have spoken to on the Hill, talked mostly about spending, whether it is defense or entitlement programs or it is in the discretionary nondefense area, and we have talked about taxes, whether we roll back, or change, or surtax, or standby tax.

FAIR TAX LEGISLATION

But what we have not discussed very much thus far—and I hope we will—is the notion of a fundamental overhaul of the tax system. Now, that is where I get back to Senator Kassebaum's question and your response to that question.

There are several of us—and I am sure, on the Republican side, equally as many—who have offered suggestions which we do not believe are the be-all and end-all, but are significant in the sense that they fundamentally change the tax system.

Senator Bradley and I and others—Senator Bradley, by far and away being the man who did the work on it, and is the leader in this, and of those who share my point of view, has introduced the so-called fair tax legislation. Nonetheless, though, it is a version of a flat tax, in the sense that it reduces all rates, the highest to 30 percent; eliminates any taxes up to a certain income level, and only includes a few deductions, two of which you named as problems with the flat tax.

I do not really expect you to be able to—or maybe you would even want counsel to determine whether you should respond to what I am about to say—but I would like to, in the light of this notion of us starting to work together, know if you would be willing to meet with, out of the context of the committee hearing, Senator Bradley, myself, Senator Kassebaum, and any of those up here on the Hill, who think that maybe the only way out for us, who, in our heart of hearts—and I am not asking you to say whether you agree or disagree; please, just remain silent for one more second—know we have to do something about revenues, maybe the only way out, for the American public to accept it and for it to be politically palatable, is for us to do it in the context of making the system more equitable, without even major change. For example, Senator Bradley and I, our positions do not fundamentally redistribute income. They do not say rich folks are now going to pay a whole lot more, and poor folks are going to pay less. It does not do that.

INVESTMENTS FAVOR TAX SHELTERS

A second point about what we have to do about the tax structure is that it seems to me—and you are the expert on this, and not me, from your background on Wall Street—that a lot of our economic decisions are not made based upon the promotion of productivity. My former partner in a small law firm is a tax lawyer. I asked him to dig up some examples for me. He does not like the fair tax bill. As he points out, it will put him out of business, or reduce his business. But I asked him to put together some examples of cases where people have come in to him for advice and said, "Look, there is this small company that, if I invest a quarter of a million dollars, I think this company is going to go—but—is it better for me to put it into this tax shelter, which is not going to produce a single new job, a single bit of productivity, but it will help my bottom line?"

My former partner says he has got to advise that person to put it into the tax shelter.

So, what Senator Bradley and I are arguing is that not only would an overhaul of the system make it more fair and more equitable, but that it may very well be sound economic policy as it relates to the free enterprise system, and let the marketplace make the decisions, rather than what we now have built into the Tax Code.

That is a long, 4-minute statement about what I think is wrong, but the part of it that relates to a question is, will you consider meeting with us, anywhere, any time, under any condition, publicly, privately, secretly—I just want you to think about it; do not even answer it now—to talk about whether or not we can begin discussing the revenue side in the context of major changes in the tax system.

Secretary REGAN. Senator, I do not need counsel to answer that, and I do not even have to think about it. We are very willing to meet with you. In fact, I have already discussed with the Treasury people who are going to start the study, the necessity of getting up here to talk to Senator Bradley, to you, and to Representative Gephardt, and others, about this plan. This plan has a lot going for it. There may be some areas with which we might disagree, but recognizing the way it was introduced, as merely a starter, it is something that intrigues us.

Senator BIDEN. We are not married to every detail, but we are married to the notion that the only way to deal with this is to totally overhaul.

Secretary REGAN. We are more than willing to discuss it, and we will be discussing it with you.

Senator BIDEN. Fine.

Secretary REGAN. One other final comment on tax decisions as opposed to economic decisions. Your former partner is entirely correct. There are too many decisions being made strictly for the tax consequences and not with the economic consequences in mind.

Senator BIDEN. I must tell you, it seems as though every tax lawyer, I think, in America has contacted me to tell me what a bad idea this is, though, because it affects their bottom line.

Secretary REGAN. I understand that, but there will be plenty of other work for them.

Senator BIDEN. Thank you.

Chairman DOMENICI. Senator Quayle.

CONSUMPTION TAX

Senator **Quayle**. Thank you, Mr. Chairman.

Let me just follow up on this tax simplification idea, because I think we have got about half of the picture. I have been very supportive of the idea of simplifying the Tax Code, not only on the individual side, but also on the corporate side. And if you look at some of the proposals, most of them deal with the individual side very specifically. In the legislation that we have proposed we set up three tiers, 14 percent, 21 percent, and 28 percent, doing away with a lot of the deductions.

Conceptually, if you look at the idea of tax simplification, you are talking about an lower tax rate for individuals, with the elimination of some of the deductions and credits, and probably keeping the total revenue generally neutral. But the real trouble comes in on the corporate side. What we are going to do about the business tax?

Conceptually, if we were to follow the principles of tax simplification normally used for the individual side, lower tax rates eliminating the credits and deductions, and apply them to the corporate side, would you change the corporate tax to a consumption tax?

Secretary **Regan**. Well, I will agree that we will study it. I am not going to state in advance whether or not that will be our final judgment, but it is——

Senator **Quayle**. No, I am not talking about your final judgment. I understand you have got until December. I am just curious, as the Secretary of the Treasury, on a conceptual basis, if this idea intrigues you. It is going to take a lot of study, and if some of us who are looking at it on a very serious basis are going in a direction that is going to be confrontational, or if you are not going to accept it, I would certainly like to know that. And I am just talking in broad, conceptual terms, if you have tax simplification, would you have lower individual tax rates and elimination of credits and deductions on the individual side, and a consumption tax or a transaction tax on the corporate side—is this a direction that we ought to be pursuing?

Secretary **Regan**. Sure. When I think back and wonder sometimes what the heck I am doing here, why I ever came to Washington—and, after this morning, I may think about it again—one of the things that brought me here was to see what could be done to the Tax Code to promote savings, to promote incentive, to promote capital formation. And that will be one of the chief guides that I will have in looking at any system.

In the corporate tax area, for example, I think we probably ought to take a good look at a shift more toward expensing, things of that nature, in an effort to simplify the system. At the consumption——

Senator **Quayle**. At going toward a consumption tax on the corporate side?

Secretary **Regan**. Yes, working toward a consumption tax, so that in the United States we do more to encourage savings. Because among the industrialized countries, we have the worst record on savings of any. I think that the need for capital over the years in order to promote jobs and things of that nature will certainly be one of the major considerations in anything we do with the Tax Code.

Senator **Quayle**. Well, I will take that in general terms, that this is certainly an idea not only worth exploring, but you are not negative toward it.

Secretary **Regan**. Definitely.

REVENUE PERCENTAGE LEVEL OF GNP

Senator **Quayle**. OK. Mr. Secretary, do you have a level of the percentage of the GNP that the revenues, on an optimal basis, should be?

Secretary **Regan**. My own judgment is somewhere between 19 and 20 percent.

Senator **Quayle**. Between 19 and 20 percent.

Secretary **Regan**. Under current conditions, that is, recognizing the need for Federal spending at those levels.

Senator **Quayle**. And therefore, you would also in turn say that, perhaps, the expenditures should be around 20 percent as well?

Secretary **Regan**. Well, if expenditures were between 20 and 21 percent, that would leave us a deficit less than one-half of 1 percent of our GNP. That would be more than acceptable.

Incidentally, a recent study by the conference board indicated that anything below 2 percent, in their judgment, in a large, industrialized nation such as the United States would be more than acceptable.

Senator **Quayle**. And the revenues right now are about 18.5 percent, right, somewhere in there?

Secretary **Regan**. Well, they are about 19 percent now.

Senator **Quayle**. Revenues are over 19 percent?

Secretary **Regan**. The exact figure is 19.2 percent, projected for fiscal year 1985.

Senator **Quayle**. So, 19.2 percent. So, as we look toward this year or the future, on a long-term basis, you are really suggesting that we ought to have far more spending reductions than revenue increases?

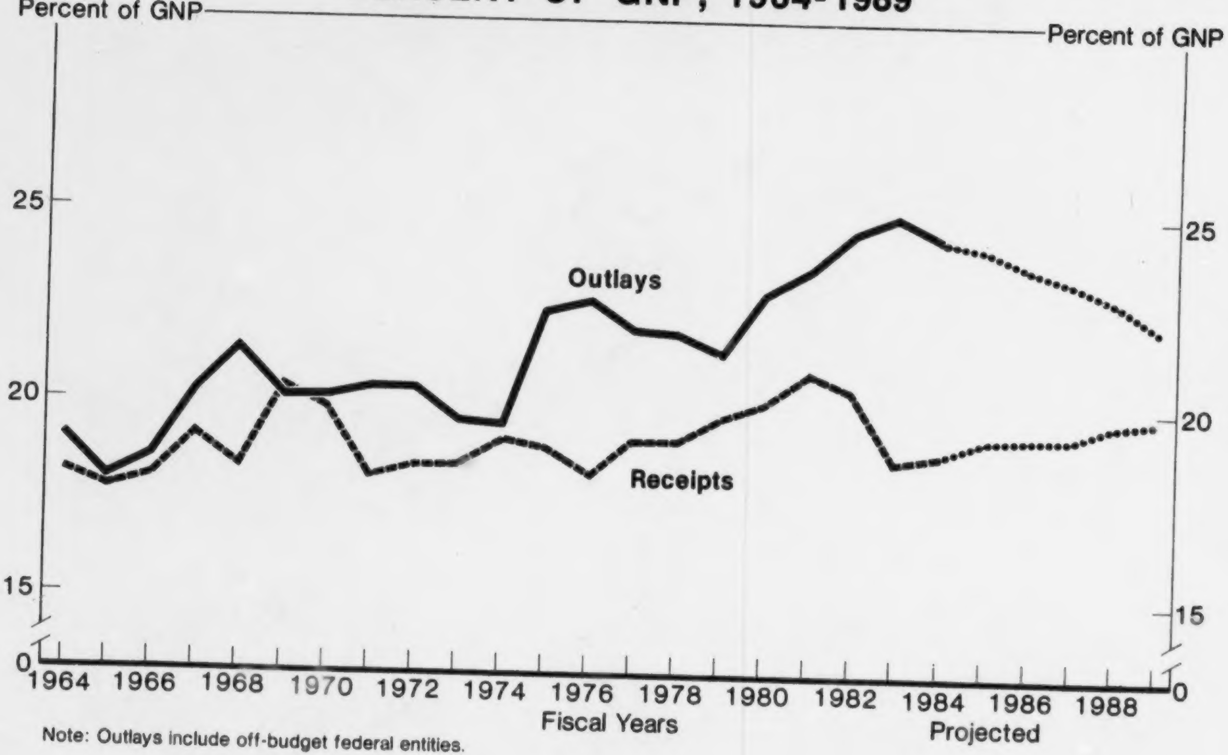
Secretary **Regan**. That is what I would hope, yes.

FOCUS MORE ON SPENDING REDUCTION

Senator **Quayle**. And therefore, as we go into the discussions of the bipartisan commission, and looking to the future, as we talk about this, we are really going to have to focus more on the spending reduction side than the taxes; is that correct?

Secretary **Regan**. I am not sure of that in regard to the downpayment. I do not want to preclude anything in regard to that before we get into the negotiations. But definitely, next year, as we look at the structural side of the deficit—what this chart here is showing—the only way to reduce that structural deficit, really, is from the spending side.

OUTLAYS AND RECEIPTS AS PERCENT OF GNP, 1964-1989



Note: Outlays include off-budget federal entities.

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Senator **Quayle**. Do you mean the downpayment could be more taxes than spending?

Secretary **Regan**. No, no, no. Let me not leave that impression.

Senator **Quayle**. Oh, OK.

Secretary **Regan**. I think it should be balanced, at least balanced.

Senator **Quayle**. Well, 50-50?

Secretary **Regan**. At least.

Senator **Quayle**. At least 50-50. So in other words, a 50-50 split, using the President's $100 billion state of the Union figure, if we had $50 billion in revenues and $50 billion in spending, that would be acceptable.

Secretary **Regan**. Because then, you would also have some further deficit reduction in the form of less interest on the debt.

Senator **Quayle**. Well, as one who is not on the Commission, but talking with other members who are, I just implore you—we have to get something this year. Deficits do matter. I think you believe that deficits do matter, and you are talking about crowding out prospects in the out-years. And I think you are probably going to just have to get everybody in a room sometime, and lock the door, and not let them come out until they get an agreement.

Now, are you getting close to getting them in that room and locking the door, so we can get an understanding, because time is running out. Once we get beyond April, we might as well forget it.

Secretary **Regan**. Well, I have heard that the initial meeting will be next week.

Senator **Quayle**. The initial meeting will be next week, and you are going to get them all together——

Secretary **Regan**. I am not sure what all means, but I know at least that the representative of the Senate minority and the representative of the House majority will meet with us next week.

Senator **Quayle**. And to determine an agenda, probably, not necessarily specifics—you do not know?

Secretary **Regan**. I do not know.

INTEREST RATES

Senator **Quayle**. Well, whatever we can add to encourage that, I think, is helpful.

Mr. Secretary, one final area of discussion. Interest rates today, the prime is at 11, 11¼ percent, something like that——

Secretary **Regan**. Eleven percent.

Senator **Quayle**. Eleven, OK. Inflation is still, on an average basis, at below 4 percent, at least, last year's figures. You have got a gap of the real interest rate figure at 7 percent.

If, in fact—and I detect from your earlier comments that the deficits do not drive up interest rates—is that correct—did you say that?

Secretary **Regan**. Not necessarily; no.

Senator **Quayle**. Not necessarily. What keeps those interest rates up high, then?

Secretary **Regan**. Fear of future inflation, for the most part, although we have prepared had a paper at Treasury, indicating that volatility of monetary aggregates action also contributes.

Senator QUAYLE. What triggers the fear of future inflation—deficits?

Secretary REGAN. No—how the deficits will be handled. In other words, there are ways to handle the deficit. Aside from monitization, there are probably three major ways—(1), by reducing expenditures; (2) by increasing taxes; and 3) by borrowing.

Senator QUAYLE. What I am trying to ascertain is whether deficits trigger this inflationary expectation that you say keeps interest rates at an unprecedented high on a real basis. Is the deficit the key culprit in this? If it is not, perhaps you can——

Secretary REGAN. Well, let's take a look at the Japanese experience. The Japanese right now have a budget deficit that is larger than ours as a percentage of their gross national product, yet their inflation rate is lower than ours. So, there is a high deficit, and low inflation, and low rates of interest. Their rates of interest in Japan are much lower than ours. So you cannot say that high deficits necessarily bring high rates of interest—that there is a linkage.

Senator QUAYLE. There has to be a linkage.

Secretary REGAN. But it is not the only and sole cause.

Senator QUAYLE. I am not saying that. But there has got to be some linkage between the high interest rates and the high deficit——

Secretary REGAN. Certainly. My argument——

Senator QUAYLE. And I know you are not going to say—and I am not trying to get you to say—that that is the only cause of the intolerably high interest rates, but I am very nervous about the interest rates.

Secretary REGAN. So am I.

INTEREST RATES KEY TO THIS ECONOMY LASTING

Senator QUAYLE. In fact, if they start to go up this spring or early this summer, that is going to spell potential economic troubles. And, whether it is the expectation of inflation or whatever other scenario you want to devise, I am very, very concerned. That is why I think it is essential that we do something on the downpayment—to keep those interest rates from going up. You know all the devastation and the ripple effect of high interest rates, when everything starts to taper off. Unfortunately, my State and the Senator from Michigan, feel those things first. We are doing all right at least in Indiana right now, but I am extraordinarily nervous, and whatever accommodation you can do—and we will have Chairman Volcker here later on—those interest rates are a key to whether this economy is going to last the next 12 or 14 or 16 months, or whatever you think it is going to do.

Secretary REGAN. I agree with that, Senator.

Senator QUAYLE. Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you, Senator.

Senator Johnston.

SHADES OF OPINION

Senator JOHNSTON. Mr. Secretary, I would like to get back to the "shades of opinion" difference between you and Dr. Feldstein.

You did refer to that as "shades of difference." I must say, to me, it looks like diametric, complete, total difference of opinion, I mean, to the point where you say that only the first eight or nine pages of the Report is a valid report and the rest is not. To disavow his opinion, I think, to be candid, is really a total, diametric difference of opinion.

Now, would you care to define where you and Dr. Feldstein disagree?

Secretary REGAN. Well, I do not think that I have the time to go through it chapter by chapter at this particular moment. You have got to remember——

Senator JOHNSTON. Am I unfair to call it "diametric and total"?

Secretary REGAN. No, I do not think diametrically is the right word. There are lots of things in there that I disagree with. I disagree with the assessment of the dollar. I disagree with saying that only the deficits are responsible for high rates of interest. I disagree with some of the rhetoric expressed as to what happens in the future. I disagree with the disavowal——

Senator JOHNSTON. Well, if I may interrupt——

Senator CHILES. Don't interrupt.

Secretary Regan. With the disavowal of this budget. I support this budget. Apparently, he does not. It is the President's budget. I am supporting the President.

Senator JOHNSTON. You do not think it has been superseded, in other words, by the——

Senator REGAN. Far from it. If that is so, then we at Treasury have got to go back and come up with a new budget. He would have to go back at CEA and come up with a new budget. At least 90 percent of this budget has to be passed, or else the whole Federal Government collapses. So you cannot walk away from this. This is the President's budget. It is not fair to the President to disavow it.

DEFICITS ARE TO BLAME FOR HIGH RATES AND TRADE GAP

Senator JOHNSTON. The Wall Street Journal this morning, in speaking of the economic report, the headlines of the article were: "Economic Advisors' Report Say Deficits are to Blame for High Rates and the Trade Gap."

Would you also disavow that?

Secretary REGAN. Well, the trade gap primarily comes about from (1) the strong dollar, and (2) the lack of competition, competitiveness, in production of certain products here in the United States. We are trying to rectify that through better management, better cost controls, things of that nature. But there is no doubt that American products have suffered over the last decade in competition with foreign products.

Senator JOHNSTON. Is it as a result of the deficit, or as a result of——

Secretary REGAN. That has nothing to do with the deficit. Rather it is a matter of Toyota or Chrysler. The Japanese have been able to make a better car, and as a result, they can outsell us. That has nothing to do with deficits. But that has a lot to do with our trade gap and the trade deficit. That is what I am trying to point out, that you cannot single out one thing and say that one thing, and one thing only—be a Johnny-One-Note in other words. You have to look at the totality of what has happened.

LESS BORROWING FOR INVESTMENT

Senator JOHNSTON. Mr. Regan, it appears that there is less borrowing for investment at this stage of this recovery than in almost any other recovery that I can recall. Most recoveries are, what, 3 or 4 years in length——

Secretary REGAN. Thirty-nine months, as an average.

Senator JOHNSTON. All right. And of course, the first year, you use up the factory space that has been vacant, you heat up consumer demand. The second year, you usually begin to invest in new plant and equipment, and borrow to do so. That has not happened in this second year.

Would you care to comment on why that is?

Secretary REGAN. Certainly. I think that the lack of borrowing you allude to primarily is a result of the work that this administration and this Congress did in passing the 1981 Tax Act. That has produced cash flow for corporate America that is unprecedented. At this particular time, not only because of the return to better profitability in 1983 as a result of stronger sales and better productivity, but also because of the reduced tax rates, corporate America should be able to finance itself, at least through 1984. Most of the flow of funds figures that I have seen as to what the demands will be on the private sector and what the supply will be seem to indicate that corporate America can almost finance itself without terribly much borrowing in 1984. That is the reason you have not seen all that much borrowing.

There has been an awful lot spent for new equipment and the like. One thing I might point out here, Senator—I do not want to go on too long and take up too much of your time—but I do want to point out that in the fifties and sixties, we had the so-called smokestack America, where you had new plant and equipment, huge plants, being built. Today, about 70 percent of us are employed in the service producing sector of the economy. This does not take as much in the way of new plant and equipment on the old-fashioned variety, but rather computer usage, office building space. Those are the things that are being bought in this recovery so far. I think that the large factories and smokestack America will start to come back in late 1984 and in 1985.

Senator JOHNSTON. Turning to 1985—and I take it you think we are safe through 1984, that the cycle of high interest rates and recession will not come on with these policies through 1984—are you pretty confident of that?

Secretary REGAN. Reasonably, yes.

Senator JOHNSTON. You think that if we——

Secretary REGAN. Something could go wrong. You know Murphy's law. But as we now see it, in early February 1984, it does look like there will not be crowding out this year.

MASSIVE PROGRAM OF DEFICIT REDUCTION IN 1985

Senator JOHNSTON. All right. Now, in 1985, I take it you think there has got to be a rather massive program of deficit reduction at the time—is that correct, a massive program?

Secretary REGAN. That is correct.

Senator JOHNSTON. Of what amount?

Secretary REGAN. It will be primarily on the spending side. I would not want to put a figure on it at this particular moment. It is something that is going to have to be worked out in more detail as time goes on, and it will have to be something that will be worked out with this Congress.

Senator JOHNSTON. You cannot give us any magnitude?

Secretary REGAN. We have none in mind at the particular moment, except as a percentage of GNP. As I responded in answer to previous questions, I do think that the Federal spending, as a percentage of GNP, should be brought down somewhere, hopefully, into the 20 or 21 percent area.

Senator JOHNSTON. But in order to do that, you have got to deal with defense and entitlements, do you not—one of the two, or both?

Secretary REGAN. That is a reasonable summation of what has to happen.

Senator JOHNSTON. Are you aware of the fact that in defense, we are putting so many of these systems under contract now, that will very soon be very difficult to dislodge from their spending—and we spoke yesterday about the two carriers. Once you lay the keel on those carriers and put them under contract, you get so far along, you really cannot stop them. It does not do any good to try to stop them, or indeed, slow them down. We are getting to that point, for example, on B-1. We are not there yet. We are getting to that point on MX. We are not there yet. But very soon, we will be; by 1985, we may be.

Are you concerned about that, that if we have so much momentum in defense, it is going to be very difficult to bring back that rate of increase?

Secretary REGAN. Well, I am not an authority on defense, obviously. It is my understanding, though, in listening to the experts, that the Defense Department has been reasonably careful on the spendout rate, doing and asking for things that they feel are really necessary for the defense of the country. There have been enormous savings suggested by the Grace Commission. I have not had time to examine them. But I would suspect that there are some places where some shadings can be made.

Senator JOHNSTON. Thank you, Mr. Chairman.

Chairman DOMENICI. We are going to go around a second time. Senator Andrews.

HIGH VALUE OF DOLLAR CONTRIBUTES TO TRADE GAP

Senator ANDREWS. Mr. Chairman, I appreciate the opportunity to follow up on some of the good discussion that has ensued between my colleague from Louisiana and the Secretary.

Mr. Secretary, you were talking about the trade gap, and you were talking about the fact that they buy more Japanese cars in this country because they are high quality. Well, actually, isn't that trade gap because of the high value of the dollar?

Secretary **Regan**. Partially. That is what I said to Senator Johnston, but that is not the only reason.

Senator **Andrews**. No. But you also pointed out——

Secretary **Regan**. You have got to remember also, Senator, that a large volume of imports, not only of automobiles but of other things, was occurring even in the period when we had a weak dollar, that is, during the period of the latter part of the seventies.

Senator **Andrews**. That is very true, but the economy did not go to smash until we had that massive trade deficit, which we now have, which is caused by some of the inability of selling goods overseas. Our farm economy——

Secretary **Regan**. Oh, no. The economy went smash in late 1979 and into 1980. That was the first of the recessions, and we had a current account surplus at that point. In 1981, it again went smash, and at that particular point we did not have the large trade gap that we have currently.

Senator **Andrews**. Well, if you look at the base of the economy as the producers of new wells—and that is the farmers that I represent—they have got a lot tougher times now than they did have three years ago, or than they had in 1979, by far, and no amount of commodity price support programs is going to bail them out. They are simply not able to sell their grain overseas because the value of the dollar is so high to support the deficit here.

Now, as you mentioned a minute ago, the Japanese have a high deficit, yet they have low interest and low inflation. That is absolutely true, Mr. Secretary. But they also invest in their economy.

ECONOMY INVESTMENT

Isn't it true that today, the investment by Americans in our economy is at almost an all-time low, and we are getting to be more and more like a "banana republic"—we have got to depend on other countries to come in and buy some $70 billion worth of our Treasury bills?

Secretary **Regan**. No, Senator. In the first four quarters of this recovery since the low spot at November 1982, business capital investment is up 11.5 percent in real terms. The historical average for past recoveries is 5.7 percent. So, business has been increasing investment a lot more rapidly in this recovery than usual.

Senator **Andrews**. Business has been doing well, but in the overall economy.

Secretary **Regan**. Well, I am talking about the overall economy and the important investment part of it.

Now, from the point of view of the farmers, as I pointed out to Senator Exon, true, the high dollar has been partly responsible for lack of sales abroad of farm products, but that is not the only reason. There is also the added production—more production in Canada, more production in Australia, more production in Western Europe, and more production in Argentina than ever before. So we are having a lot more competition facing our products abroad. Even if the dollar were down, the Farmer would still have to compete with that added production.

INVESTMENT AT 2.4 PERCENT OF SAVINGS

Senator ANDREWS. Well, let's get back to these statistics, because we seem to have spent a lot of time arguing about whose statistics are accurate, and whose are not quite so accurate.

I am totally surprised, because I was told by a number of different economists over the last year or two that the investment in this Nation was at a rate of about 6.9 percent savings in the 1960's. It is now down to 2.4 percent. Isn't that true?

Secretary REGAN. Well, that is the residual figure that is put out by the——

Senator ANDREWS. Well, that is the savings, isn't it?

Secretary REGAN. It is not true based on the Federal Reserve Board's figures. It depends on which set of figures you want to look at.

Senator ANDREWS. Well, these were on the front page of the Wall Street Journal as of——

Secretary REGAN. That does not impress me.

Senator ANDREWS. Well, it does not impress you, but we have got to get our statistics somewhere.

Secretary REGAN. Well, it depends. There are at least two sets of figures on personal savings in the United States. That is what I am trying to tell you, Senator. Either one or both of them could be correct, but they differ.

Senator ANDREWS. You are saying that savings are at the same rate in the United States now they were in the 1960's?

Secretary REGAN. Not quite, but they are not as bad as suggested by the figures that you have cited.

Senator ANDREWS. How much foreign money do we have to have come in and buy our Treasury bills this year? Am I wrong when I was saying that about $50 billion——

Secretary REGAN. How much do we have to have? Answer: None.

Chairman DOMENICI. Would you yield, Senator?

Senator ANDREWS. Sure, I would be glad to yield to the Chairman.

PERCENT OF GNP IN TOTAL SAVINGS

Chairman DOMENICI. Mr. Secretary, could we get your estimate of what the level of savings is? You say that the low number is wrong and somebody else's might be right. What do you use as the percentage of GNP that Americans are saving?

Secretary REGAN. Well, first of all, I look at total savings. What the Senator has been referring to here are personal savings. There are a lot of savings that are not included in that. I look at total savings overall.

Chairman DOMENICI. What is the percent—do you know?

Secretary REGAN. The percent of total savings in GNP? I do not have that in my head—[conferring with staff]—17.2 percent of GNP in 1983, and back in 1964, it was 16.7; in 1971, it was 16.7. It has risen as high as 18 percent in 1975; it was 16.8 in 1979.

That is gross private savings as a percent of GNP—gross private savings, not just personal but corporate, including retained earnings, and the like, as well as personal. These are Commerce Department figures.

Chairman **Domenici**. We are used to using personal savings. Is that broken out? I am not saying the gross is irrelevant, but I am saying that most people use personal.

Secretary **Regan**. I know they use personal, but you have to take total gross saving into consideration, because that is what business uses, or what is available to the Federal Government. As for the personal savings rate, this table has it at 4.8 percent for 1983; it was, as the Senator suggested, in the 6 percent range back in the late seventies; it did hit 8 percent in 1971.

Senator **Andrews**. And it is now where?

Secretary **Regan**. 4.8 percent.

Chairman **Domenici**. Let me ask one more question.

Senator **Andrews**. Yes, sure.

Chairman **Domenici**. Regarding the 16 and 18 numbers, this bothers me because I have never heard of such a number, so let me see if I have it right.

On the business side, that is a very large component, and includes depreciation, does it not?

Secretary **Regan**. That is true—and retained earnings.

Chairman **Domenici**. So that depreciation part may not be liquid; it could be bookkeeping.

Secretary **Regan**. Partially, true.

Chairman **Domenici**. Now, let me ask you, how much do you think, or does your Department estimate, foreign——

Secretary **Regan**. But it has to be both.

Chairman **Domenici**. Oh, yes—as a percent of GNP, how much do you estimate is now foreign money in America? I am not now talking about buying farms——

Secretary **Regan**. Do you mean total foreign investment owned in the United States?

FOREIGN MONEY IN AMERICA AS A PERCENT OF GNP

Chairman **Domenici**. No. Let me put it another way. How much foreign money is available now as a percent of GNP in this same, overall money availability ballpark that you are referring to?

Secretary **Regan**. Last year, I think the figure was around $40 billion of foreign capital, either equity or debt, came into the United States on net, short and long term.

Chairman **Domenici**. What is that, 1.2 percent of GNP, or thereabouts?

Secretary **Regan**. GNP is probably—it is probably 2.5 percent.

Senator **Chiles**. What percent of our Government securities——

Secretary **Regan**. One and one-quarter percent, I am informed. Excuse me, I was doubling it.

Chairman **Domenici**. OK, 1¼. Now Mr. Volcker, at a conference in Miami, said that the Federal Reserve estimated that foreign money was at its highest ever, and that it was probably now 2 percent of GNP. You would not——

Secretary **Regan**. I think that is on the high side, although he may have figures which differ from mine. There is a big discrepancy, you know, in the balance-of-payments figures. In 1982, the discrepancy was $41 billion. Errors and omissions is what they call it, and it was $41 billion.

CONCERN ABOUT FOREIGN CAPITAL MOVING OUT

Chairman **Domenici**. The reason I asked the question—and I will yield right quickly back to the Senator, and Senator Chiles wanted to ask a question—the business community that was meeting at this extraordinary conference down in Florida was very concerned about the possibility of that money moving back out, which would clearly precipitate the crowding out problem and make it much more current in terms of time.

Is there any fear on your part that the extraordinary amount of foreign capital available here could move out quickly?

Secretary **Regan**. Well, first of all, you would have to find out how it is invested now. If it is invested in office buildings, ranches, farms, or things of that sort where there are foreign large amounts of long-term foreign investment in the United States, that money cannot move quickly and will not move quickly.

Now, there is another portion of that money that is in foreign reserves, that is, central banks are holding debt, I do not think that will change very quickly, because this is reserve currency, the dollar is the reserve currency; that will not change. There is some amount that is probably in the stock market, or perhaps in very short-term debt instruments in the United States. That might move, but it will not be the entire $40 billion, absolutely not.

MASSIVE DEFICITS FUNDED BY FOREIGN INVESTMENT

Senator **Andrews**. Well, Mr. Chairman, I appreciate you getting into this. The problem that we have, Mr. Secretary, is that we are not graduate economists. We are trying to get some accurate figures so we can find out what direction we are moving. And one of the things that has bothered me about the deficit, the stories that I have read, not just in the Wall Street Journal, but in a whole host of different ones—the National Journal and others—that we get, so that we can be as up-to-date with the facts as we possibly can be—one of those statistics, as I recall it, pointed out that foreign currency will buy some $60 to $70 billion this year of Treasury bills.

Now, I was up on Wall Street in your old haunts, in December, talking to some of the leaders in those firms, Mr. Secretary, and their major concern is the fact that these massive deficits are now having to be funded to a great percentage by foreign investment. And, as the chairman pointed out a moment ago, the speech that was made by another Federal official to a group of businesspeople pointed out the dangers of that kind of foreign investment, because if they begin to get a little skittish, any move in the wrong direction in our economy would be emphasized to a much greater degree than normal.

It was also pointed out that in order to get that foreign investment to fund our economy, our deficit, we had to keep our dollar abnormally high, and we had to artificially prop up interest rates to get that money coming in.

Is this story essentially true, or has the chairman, and I think Senator Chiles and myself, been laboring under some false group of figures?

FOREIGN CAPITAL COMING IN KEEPS DOLLAR STRONG

Secretary **Regan**. Well, let's take a look at it, and examine what you are saying. As long as we are having foreign capital coming in, the dollar remains strong. You would like to see a weaker dollar, because you want to sell more products overseas, and you say that the strong dollar is impeding our selling products overseas——

Senator **Andrews**. Well, if the strong dollar is caused because of an interest rate that is much higher than it ought to be, based on our rate of inflation, that is a hell of an impact on the working men and women of this country, and that is one of the concerns we have on this committee.

Secretary **Regan**. That is why I am trying to answer you, Senator. Now, let's follow that to its conclusion. If you then decide that you want a weaker dollar, then we go back to where we were in the late seventies, when everyone, including Wall Street—and I was there then—was saying we should have a stronger dollar. But now we want a weaker dollar, we want to go back to the weak dollar. We cut interest rates here. If the rest of the world is not in an economic growth situation, who do you think is going to invest in those other countries rather than the United States?

It does not make any sense. If you have an institution with hundreds of millions of dollars, say you are in a Scottish trust insurance company, or you are a banker in Switzerland, or a German investor, and none of the economies in the rest of the world are recovering except the United States, and we have lower rates of interest, would you pull your money out of the United States? No.

That the dollar might not necessarily weaken is what I am telling you, even with a low rate of interest. These conclusions—some of these people are going to outdo the Olympics on the broad jump here as to conclusions that all of this is going to happen all at once. These conclusions gloss over the actual facts of what could happen. A lower rate of interest could mean a weaker dollar, and a weaker dollar could or could not result in less investment in the United States.

LOWER RATE OF INTEREST WOULD BE HEALTHY

Senator **Chiles**. Well, I do not think that is the proposition that some of us are making. I am not concerned about that at all. I think a lower rate of interest would be healthy——

Senator **Andrews**. Very healthy.

Senator **Chiles**. Healthy for the dollar, healthy for our exports, healthy for the foreign banking problem—so I think you have kind of turned this around and said lower interest.

Senator **Andrews**. Healthy for the housing industry.

Secretary **Regan**. No. What I meant——

PERCENTAGE OF T-BILLS HELD BY FOREIGN INVESTORS

Senator **Chiles**. Let me ask you this. You know, one of our greatest exports today is T-bills. That is one place where we are doing well in exports. What percent of our T-bills are held by foreign investors? Can you give me that?

Secretary **Regan**. We have no idea on that, because——

Senator CHILES. You have no idea?

Secretary REGAN. No.

Senator CHILES. That scares me to death.

Secretary REGAN. Why? Let us be sophisticated, Senator. If the Morgan Guaranty Bank buys $100 million of T-bills at the auction next Monday, for whom are they buying? Are they buying for a foreign account, are they buying for a trust account, are they buying for the bank's account? They do not tell us. They are buying T-bills. Why does that scare you to death?

Senator CHILES. Well, it scares me if the Treasurer of the United States has no idea of what the amount of these T-bills, how many are bought and exported, in effect.

Secretary REGAN. They are not exported, Senator. That would be the most unsophisticated manner of taking delivery on a T-bill that is due in 91 days—sending it abroad. It stays right here in the United States. It is not exported.

Senator CHILES. Well, all right. So, the paper has not been exported, but the money has been imported——

Secretary REGAN. Not all T-bill money is imported.

Senator CHILES. No, not all. I want to know what percentage—then, can you tell me how much has been imported, if you cannot tell me how much has been exported?

Secretary REGAN. That is what I am trying to tell you. Trying to chase that down, you will have to find out why and for whom each purchase is made. And the ownership of these is only disclosed as a bank or an intermediary.

Senator CHILES. Well, I would just hope that somewhere there is somebody who has some idea. So, it could be 50 percent—if you do not know.

Secretary REGAN. Well, the chances of it being——

Senator CHILES. Well, I see your fellow behind you, shaking his head, "No." I mean, it could not be 50 percent. That makes me feel a little better.

Could it be 15 percent?

Secretary REGAN. It probably is less than 5, in my judgment, because of the amount of money involved—it would not be worth it to be investing in 91-day money. Remember, this is very short-term money, and that is not sloshing around in the world——

Senator CHILES. Well, what I am really getting at is—let us say it is 10, or 15, or 5, or whatever it is——

Senator ANDREWS. Would my colleague yield for a minute?

Senator CHILES. Yes.

Senator ANDREWS. The National Journal 2 months ago said $65 billion worth of T-bills were currently owned by foreign countries. The National Journal may be totally wrong, but they are a source that we have to look to.

LESS FOREIGN INVESTMENT COULD ACCELERATE CROWDING OUT

Senator CHILES. Well, I want to include all Government debt—long-term, I mean, T-bills, and all that. What I am getting at is, if that money starts to go—and is it necessarily just because we get a nice, lower interest rate that all of us want—it can be because they finally get scared to death of our deficit, or they get scared of where our economy is going, or they decide that money flees for different reasons. But let's say it starts to go for there—that certainly could accelerate the crowding out problem. And we know that we have benefited over the last year, tremendously, by this foreign investment as far as our crowding out. We are hurt on the other side, where that trade deficit is, but we have been benefited with the crowding out. I am trying to get some kind of appreciation of what our danger is there, toward speeding up the crowding out.

Now, you said yesterday in your statement to the Finance Committee that you did not think we had to worry through 1984, but you were concerned about 1985. Now, certainly, you would have to be more concerned, and we all would, if that foreign investment started to leave.

Secretary REGAN. Well, two other things you have to bring in here——

Senator CHILES. Before you do that, let me add in one more thing. We are not talking about just where we are today. We are talking about how much of the new $180 to $200 billion debt that we are getting ready to put on there, how much of that will be financed by this foreign—will it continue to come in the way it has. If it just levelled off where it is now, obviously, we would be in trouble, if a good percentage of that debt last year was taken up by foreign.

Secretary REGAN. Fine. Now, you also have to consider other things when you are looking at this. There is not a simple formula for tracing this. Remember the question Senator Metzenbaum asked me as to when are we going to repatriate that $13 billion that we have as deferred taxes overseas because of DISC. There are literally hundreds of billions of dollars owned abroad by Americans, American corporations, primarily, American institutions. Are they going to bring that back at the same time this foreign capital is withdrawn from this country? Who can say? You have to take that into consideration to get a net flow of funds.

You also have to consider when you are thinking about crowding out, how much will Americans save next year; how much will corporate profits be. If foreigners withdraw there money, will there be more or less corporate cash available? It is a very complex formula.

What I am telling you is that if we continue these large deficits, we do run the danger in 1985—and I have been saying this for 2 years, now—in 1985, we probably will get into a situation of crowding out because of the larger demand for credit from American business than we have had in 1983 or likely to have in 1984.

FOREIGN DEBT

Senator CHILES. You also made a quick answer to one of the questions when you were asked how much of the foreign debt would we have to have, and you said none. Now, if we had none today, would we not be in trouble with crowding out?

Secretary REGAN. No, not in 1984, not today. Now, 1985 is something else, again. But today, we do not need it. We will in 1985, and that is what I am trying to point out to you, Senator.

Senator CHILES. We do not need any of it for financing this $180 billion?

Secretary **Regan**. Not the deficit. We do need it to finance the trade gap. We do not need it to finance the budget deficit. There are two different things you are talking about here—the trade gap or the trade deficit and the budget gap or budget deficit. These are two different things.

Senator **Chiles**. Well, it seems to me if we had none today—we know that there is a lot of foreign money in here—if we do not have any for that, and we do not have any for the new that is coming on, I think we would have to be in trouble in 1984.

Secretary **Regan**. Are you talking about foreign capital or foreign borrowing?

Senator **Chiles**. Foreign investment in our capital.

Secretary **Regan**. Yes, but you see, American banks can also go abroad to the Euro-dollar market. There is a huge market over there, probably a trillion dollars, in the Euro-dollar market which is centered in London, and our banks can borrow over there. Up to this point, they have been lenders into that market. They could be borrowers over there, so you could borrow that money out, also. You do not need it as investment. It would be borrowing. You have got to keep that in the formula, also.

Senator **Chiles**. I give up.

[The following was subsequently supplied for the record:]

Ownership of the Public Debt

The following provides data on ownership of the Federal debt and comments on how interest payments on this debt might affect the distribution of income.

Ownership of Public Debt Securities

Table 1 attached provides data on ownership of public debt securities as of year-end 1980, year-end 1982, and September 1983, the latest month for which figures are available. Attached also is the table from the Treasury Bulletin containing the most recent data. Relevant footnotes may be found in that table.

As may be noted from Table 1, a little over 70 percent of the debt is privately held (outside U.S. Government trust accounts and the Federal Reserve). About 12 percent of the total is held by foreign investors, a share that has declined markedly over the past few years. It was about 17-1/2 percent at the end of 1978.

The "other" category of holders is large and growing. It includes corporate pension funds, private nonprofit institutions, savings and loan associations, mutual savings banks, credit unions, and miscellaneous other organizations.

Individuals hold a substantial share of the debt directly (9.3 percent in September 1983) and an additional share indirectly in the form of money market fund shares and claims on corporate and state and local government pension funds. Individuals, of course, as stockholders own the commercial banks, savings and loans, corporations, and other holders of major portions of the debt.

Impact on Distribution of After-Tax Income

Data are not available to measure the impact on the distribution of income and wealth of taking dollars from taxpayers and transferring those dollars as interest payments to holders of the public debt. Quite generally, however, interest income from all sources is spread across all income classes more evenly than the burden of income taxes.

Inequalities in distributions of income, wealth, and tax burdens are often measured by Lorenz curves. The chart attached plots those curves for interest income and for taxes paid, based on tax return data for the year 1981. A diagonal (45°) line would represent perfect equality of distribution. The greater the departure from that line, the greater the inequality. As may be noted from the chart, inequality of the distribution of interest income received was substantially less than that of income taxes paid, both based on tax returns filed as classified by size of adjusted gross income. As an example, roughly 24 percent of all interest income reported by tax filers was received by the roughly 50 percent reporting the lowest adjusted gross income (under $14,000). These same one-half of tax filers paid about 8 percent of income taxes in 1981.

This, of course, does not indicate how the distribution of after-tax income might be affected by an increment in the public debt. It is suggestive, however, that debt holdings of all types are quite widely dispersed across income groups and that interest payments would not go predominantly to one group.

Ownership of Federal Debt

	Level, billions of dollars			Percent distribution		
	Dec. 1980	Dec. 1982	Sep. 1983	Dec. 1980	Dec. 1982	Sep. 1983
Public debt securities - total	930.2	1197.1	1377.2	100.0	100.0	100.0
U.S. Govt. accounts	192.5	209.4	239.0	20.7	17.5	17.4
Federal Reserve	121.3	139.3	155.4	13.0	11.6	11.3
Privately held	616.4	848.4	982.7	66.3	70.9	71.4
Commercial banks	112.1	131.4	176.3	12.1	11.0	12.8
Individuals	117.1	116.5	128.5	12.6	9.7	9.3
Savings bonds	72.5	68.3	70.6	7.8	5.7	5.1
Other	44.6	48.2	57.9	4.8	4.0	4.2
Insurance companies	24.0	39.1	n.a.	2.6	3.3	n.a.
Money market funds	3.5	42.6	24.0	0.4	3.6	1.7
Corporations	19.3	24.5	35.5	2.1	2.0	2.6
State and local govts.	84.4	113.4	n.a.	9.1	9.5	n.a.
Foreign and international	134.3	149.4	160.8	14.4	12.5	11.7
Other	121.7	231.5	n.a.	13.1	19.4	n.a.

Source: Treasury Bulletin

OWNERSHIP OF FEDERAL SECURITIES

Table OFS-1. – Distribution of Federal Securities by Class of Investors and Type of Issues

[In millions of dollars]

End of fiscal year or month	Total Federal securities outstanding	Interest-bearing public debt securities: Total outstanding	Held by U.S. Government accounts: Total	Held by U.S. Government accounts: Marketable	Held by U.S. Government accounts: Nonmarketable	Public issues held by Federal Reserve banks
1979	833,751	819,007	187,683	11,379	1/176,304	115,458
1980	914,317	906,402	197,743	10,078	187,665	120,711
1981	1,003,942	996,495	208,076	9,016	199,060	124,330
1982	1,146,987	1,140,883	216,404	7,944	208,460	134,393
1983	1,381,886	1,375,751	239,023	5,887	233,136	155,423
1982-Sept	1,146,987	1,140,883	216,404	7,944	208,460	134,393
Oct	1,147,713	1,136,826	210,986	7,061	203,925	132,080
Nov	1,166,569	1,160,489	203,920	6,385	197,535	137,676
Dec	1,201,890	1,195,496	209,355	5,976	203,379	139,312
1983-Jan	1,205,899	1,199,599	206,958	5,962	200,996	132,364
Feb	1,220,132	1,213,742	203,274	r5,934	r197,340	135,561
Mar	1,249,312	1,242,993	201,155	5,890	195,265	136,851
Apr	1,252,706	1,242,067	201,868	5,977	195,891	r146,174
May	1,296,125	1,289,897	226,794	5,971	220,823	r141,160
June	1,324,318	1,318,111	229,291	5,904	223,387	141,673
July	1,331,595	1,320,671	224,694	5,728	218,966	144,256
Aug	1,353,072	1,346,815	225,649	5,901	219,748	146,489
Sept	1,381,886	1,375,751	239,023	5,887	233,136	155,423

End of fiscal year or month	Interest-bearing public debt securities--Con.: Held by private investors: Total	Marketable	Nonmarketable	Matured public debt and debt bearing no interest	Agency securities: Total outstanding	Held by U.S. Government accounts and Federal Reserve banks	Held by private investors
1979	515,866	379,856	136,010	7,512	7,232	1,614	5,619
1980	587,948	463,717	124,231	1,299	6,616	1,605	5,011
1981	664,089	549,863	114,226	1,360	6,086	1,586	4,500
1982	790,086	682,085	108,001	1,151	4,952	1,340	3,612
1983	981,305	862,690	118,615	1,459	4,675	1,196	3,479
1982-Sept	790,086	682,085	108,001	1,151	4,952	1,340	3,612
Oct	793,760	685,521	108,239	5,999	4,887	1,257	3,630
Nov	818,893	708,802	110,091	1,218	4,861	1,256	3,605
Dec	846,829	736,188	110,641	1,576	4,824	1,255	3,569
1983-Jan	860,273	750,329	109,944	1,461	4,859	1,235	3,624
Feb	874,907	r766,157	r108,750	1,554	4,836	1,232	3,604
Mar	905,187	r795,210	r109,977	1,698	4,819	1,229	3,590
Apr	900,024	r789,327	r110,698	5,850	4,786	1,228	3,558
May	921,924	r810,196	111,727	1,465	4,763	1,224	3,539
June	947,148	r831,352	r115,795	1,470	4,737	r1,202	r3,535
July	951,722	835,726	115,996	6,210	4,715	1,199	3,516
Aug	974,777	857,981	116,796	1,499	4,698	1,199	3,499
Sept	981,306	862,690	118,615	1,459	4,675	1,196	3,479

1/ Includes other nonmarketables of $2,056.

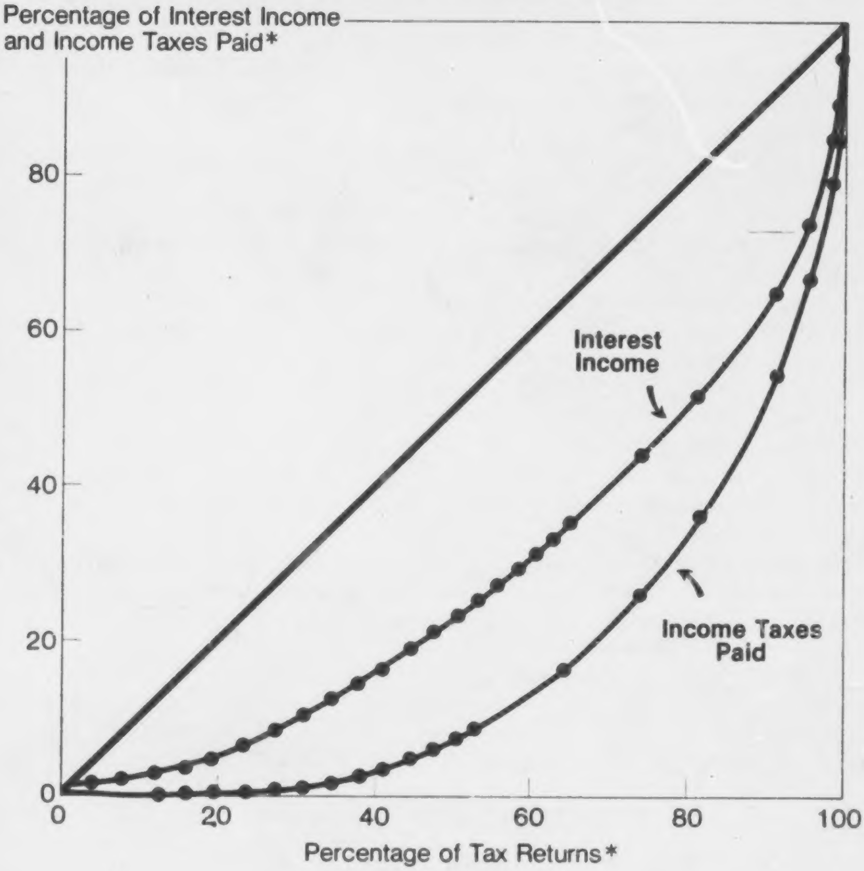
Table OFS-2. – Estimated Ownership of Public Debt Securities by Private Investors

[Par values 1/ in billions of dollars. Source: Office of Government Finance and Market Analysis in the Office of the Secretary]

End of month	Total privately held	Commercial banks 2/	Nonbank investors: Total	Individuals 3/: Total	Individuals 3/: Savings bonds 4/	Individuals 3/: Other securities	Insurance companies	Money market funds	Corporations 5/	State and local governments 6/	Foreign and international 7/	Other investors 8/
1976-June	376.4	91.4	285.0	96.1	69.6	26.5	14.4	0.8	23.3	33.3	69.8	47.2
Dec	409.5	103.5	306.0	101.6	72.0	29.6	16.2	1.1	23.5	39.2	78.1	46.3
1977-June	421.0	102.7	318.3	104.9	74.4	30.5	18.1	.8	22.1	46.8	87.9	38.7
Dec	461.3	98.9	362.4	107.8	76.7	31.1	19.9	.9	18.2	50.9	109.6	56.1
1978-June	477.8	97.8	380.0	109.0	79.1	29.9	19.7	1.3	17.3	58.1	119.5	55.1
Dec	508.6	95.0	413.6	114.0	80.7	33.3	20.0	1.5	17.3	62.8	137.8	60.2
1979-June	516.6	86.1	430.5	115.5	80.6	34.9	20.9	3.8	18.6	68.9	119.7	83.1
Dec	540.5	88.1	452.4	118.0	79.9	38.1	21.4	5.6	17.0	71.8	123.7	94.9
1980-June	558.2	97.4	460.8	116.5	73.4	43.1	22.3	5.3	14.0	75.9	122.8	104.0
Dec	616.4	112.1	504.3	117.1	72.5	44.6	24.0	3.5	19.3	84.4	134.3	121.7
1981-Mar	654.6	117.0	537.6	105.2	70.4	34.8	25.6	14.5	17.0	88.5	142.9	143.9
June	651.2	119.7	531.5	107.4	69.2	38.2	26.4	9.0	19.9	93.3	141.4	134.1
Sept	665.4	112.7	552.7	109.7	68.3	41.4	27.6	11.4	18.0	p95.7	135.5	p154.8
Dec	694.5	111.4	583.1	110.8	68.1	42.7	29.0	21.5	17.9	p99.5	141.4	p163.0
1982-Mar	733.3	116.1	617.2	112.5	67.5	45.0	32.1	25.7	16.9	p102.9	140.8	p186.3
June	740.9	116.1	624.8	114.1	67.4	46.7	32.5	22.4	17.6	p107.3	141.9	p189.0
Sept	r791.2	117.8	r673.4	115.6	67.6	48.0	34.8	38.6	21.6	p112.1	141.6	p209.1
Dec	848.4	131.4	717.0	116.5	68.3	48.2	39.1	42.6	24.5	p113.4	149.4	p231.5
1983-Mar	906.6	153.2	753.4	116.7	r68.8	r47.9	p42.4	44.8	27.2	n.a.	156.1	n.a.
June	948.6	171.6	777.0	r121.3	69.7	51.6	p44.8	28.3	32.8	n.a.	160.0	n.a.
Sept	982.7	176.3	806.4	p128.5	p70.6	p57.9	n.a.	24.0	p35.5	n.a.	p160.8	n.a.

1/ U.S. savings bonds, series A-F and J, are included at current redemption value.
2/ Includes domestically chartered banks, U.S. branches and agencies of foreign banks, New York investment companies majority owned by foreign banks, and Edge Act corporations owned by domestically chartered and foreign banks.
3/ Includes partnerships and personal trust accounts.
4/ Includes U.S. savings notes. Sales began May 1, 1967, and were discontinued June 30, 1970.
5/ Exclusive of banks and insurance companies.
6/ Includes State and local pension funds.
7/ Consists of the investment of foreign balances and international accounts in the United States.
8/ Includes savings and loan associations, credit unions, nonprofit institutions, mutual savings banks, corporate pension trust funds, dealers and brokers, certain Government deposit accounts, and Government-sponsored agencies.

DISTRIBUTION OF INTEREST INCOME AND INCOME TAXES PAID



* Classified by size of adjusted gross income.

Source: Internal Revenue Service, Statistics of Income 1981, Individual Income Tax Returns.

Chairman **Domenici**. Senator Riegle, could I take just 2, and then you can go ahead?

Senator **Riegle**. Of course, of course.

REAL INTEREST RATE STILL HIGH

Chairman **Domenici**. Mr. Secretary, first, I know you have been here a long time, and it has been a rather controversial session, especially with reference to another member of the President's advisory team and your views.

But let me just ask you, with reference to your ideas, why is the real interest rate still as high as it is?

Secretary **Regan**. I would say primarily two reasons—one, the fear of future inflation, which is the primary one, second, the volatility of money.

Chairman **Domenici**. What does the second one mean?

Secretary **Regan**. The second means that the money markets are uncertain as to what the Fed's policy will be—too tight, too loose, or gyrating back and forth. I do not need to go through the history—I think you know it—of what happened in 1981, 1982, and 1983. Therefore, a trader at a trading desk, deciding what he will pay for money as well as what he will lend it for, has to say, "Well, I do not know what the Fed is going to do. Therefore, I want a little more money."

Chairman **Domenici**. You would agree that because the real interest rate is still so large, historically speaking, is a significant negative in terms of America's economic prosperity and growth, would you not?

Secretary **Regan**. Yes, definitely.

Chairman **Domenici**. And we ought to try to get it to come down, is that right?

Secretary **Regan**. Definitely.

HOW TO LOWER REAL INTEREST RATE

Chairman **Domenici**. Now, tell me what you think we ought to do to get it to come down.

Secretary **Regan**. Well, I think we have to have a tighter fiscal policy. I think that that means, obviously, reduction of the deficit, which we would hope would be along the lines we have suggested—the downpayment this year, more to come next year—so that we reassure these money markets that we are not going to monetize our deficits in the future.

Chairman **Domenici**. Let me just stop at that one. You say there is more than one. I tend to agree there is more than one. That one can be summarized as the fear of continuing deficits that are too large. That is what you just stated.

Secretary **Regan**. Yes.

Chairman **Domenici**. You have a different version of how to fix it than do others. It is peculiarily your version and your idea. You would use fiscal policy from the standpoint of reducing the deficit; Is that your first point?

Secretary **Regan**. That is right.

Chairman **Domenici**. So we must fix that, you say, mostly on the expense side. Let me ask you, without divulging details—I would not expect you to have them—what general areas do you think the U.S. Congress ought to, in the next 6, 7, 8 years address in terms of reducing these expenditures? Do you have seven or eight major ones that ought to be addressed?

Secretary **Regan**. Well, I think Director Stockman gave this committee some suggestions yesterday, and mine would be in those same general areas. Quite obviously, there are only certain places in the budget that you can go, and I think he identified the chief ones.

WORLD IN BAD SHAPE BECAUSE OF OVERSPENDING

Chairman **Domenici**. Now, Mr. Secretary, in terms of your answers with reference to the world economy, while there are a lot of different reasons for a significant portion of the free world's economy being in rather bad shape, would you agree that one of the principal reasons is the high-interest rates?

Secretary **Regan**. The world's economy—no. I would say the world is in bad shape because of overspending, not because of high interest rates. The interest on their debt, yes, is very burdensome to them, but the reason they got into trouble, why they incurred the high borrowings on which they are now paying interest, is overspending.

Chairman **Domenici**. Well, the Europeans now—and not the Japanese yet—but the Europeans are saying—I do not know about the original cause—but they are saying there is not enough money available at reasonable rates for them to recover, leaving the implication to me that their money is coming here because interest rates are very high, and we are very solvent. If rates went down, we would all benefit, including them—is that correct—if interest rates went down significantly?

Secretary **Regan**. We could benefit. I am not being argumentative when I say this, Senator, but I do think I have to point out that if interest rates go down, and—to follow this chain—then the dollar weakens, as we said earlier, we will become more competitive with them. That may not be to their advantage, to have a more competitive United States.

Chairman **Domenici**. It is a very close call, then. When that thing starts to balance out, if they do not start to grow substantially, the mere reduction in our dollar value is not going to solve our problem—there is no question about that.

Secretary **Regan**. That is right. I recall, at the first summit that I attended, the other industrialized countries telling us that we should strengthen our dollar. Two years later, they were telling us to weaken it.

Chairman **Domenici**. Well, we are probably outlandishly strong versus them now, but I do not know how you fix it quickly.

I had a couple more questions, but I am going to yield to Senator Riegle.

REAGAN ADMINISTRATION HIGHEST CONTRIBUTOR TO FEDERAL DEBT

Senator **Riegle**. Thank you, Mr. Chairman.

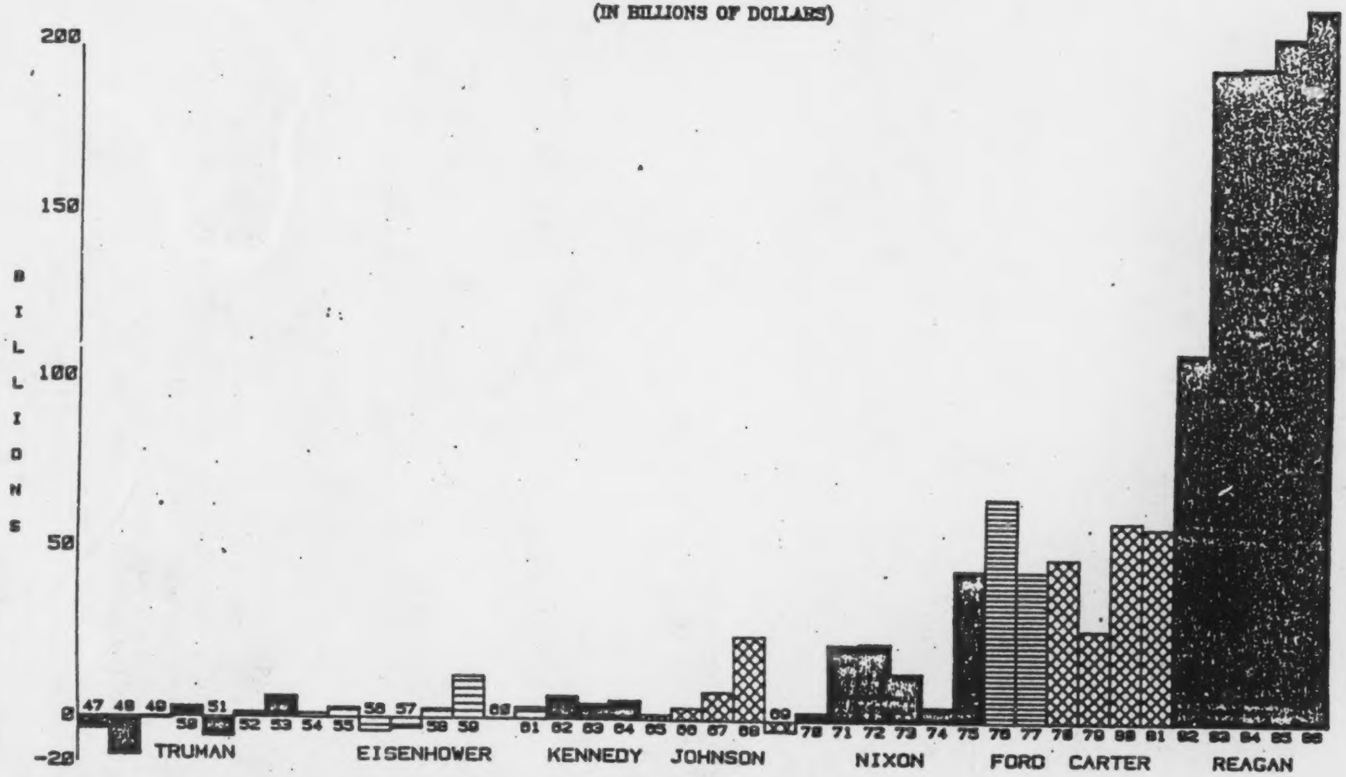
You have been very patient, Mr. Secretary, and I will not keep you too much longer here.

I have just had put up here a chart of the deficits, going back, really, to 1947 in this country and coming forward. Yesterday, this was a chart that Senator Metzenbaum put forward.

HISTORICAL DEFICITS

1947 – 1986

(IN BILLIONS OF DOLLARS)



1984-1986 FIGURES REPRESENT AUGUST 1983 CBO BASELINE ESTIMATES

HOUSE BUDGET COMMITTEE
NOVEMBER 18, 1983

Senator **Riegle**. You will notice, if you see the deficits here, that by the time we end the Carter period and get into the Reagan period, we really get into the deficits in a way that we have never been into them before. And the fact is that if you look at the numbers, and you look at the Reagan deficits as they have already accumulated, and your current budget as of yesterday would call for those deficits to continue out through 1987, you are proposing—and have already spent—between 1982 and 1987, more money in terms of deficit. You will have added far more to the Federal debt than all of the other administrations, all the rest of the history of the country.

The figures are roughly $800 billion from 1789 to 1981, whereas the numbers going forward from 1982 to 1987 are over $1 trillion.

Now, the reason I show you this chart is because I think it graphically dramatizes what has happened. We have had an enormous increase in the national deficit each year, resulting in a breakthrough on deficits to a size that we have never experienced before. So, you are in the process of more than doubling the national debt.

MASSIVE DEFICITS NOT PART OF PLAN

Now, as I mentioned earlier, Senator Domenici yesterday documented that if you take just the spending side of the deficit, that the Reagan administration has asked for more spending in total, from the first date arrived until now, than the Congress has actually granted.

So presumably, in your plan, having gotten less spending than you asked for, the spending side is along the lines of what you forecast when you started down this road 3 years ago.

On the tax side, as you know, the major tax bill passed. I voted for it. We had it on the Senator floor for 3 weeks, with 105 votes on amendments. But nevertheless, the revenue side was also put in place largely within that major tax strategy that was put forward by the administration.

Now, you have got the revenue side, you have got the spending side, and the difference, of course, is these massive deficits. And they were not part of the plan. No one foresaw that. You certainly did not. The President did not. He was promising a balanced budget at this time when, in fact, now, we are at a point where we have the largest deficits in our history.

So, that part of the plan did not work, and that is very awkward. I mean, it is, I think, dangerous for the economy, dangerous for the world economy, but it is particularly awkward this year, because the President still does not want to have to acknowledge those deficits; he is still against deficits. And yet, the fact is, as this chart shows and as the numbers show, he has become the all-time champion deficit spender in this country, and it is very awkward.

So what I think is happening is—and it is not surprising—the economic advisers are in something of a panic, because how does one explain this? I mean, how do you deal with this inconsistency, because this was not part of the plan and, lo and behold, here it is, and frankly, everybody here is worried about it—Republicans, Democrats—we all feel that these deficits are too big, and they are intolerable.

But it seems to me what is happening is that the economic advisors are not quite sure what to do about it, and it is beginning—and I just want to say to you—I have said it before, and I want to say it again now—I like you, and I think you work very hard, and I think you are a very good person to have around here and a good person to work with, and I think you have been very forthcoming today.

But I have to tell you that I think, as I watch all the economic advisers, this is beginning to look a little like a Keystone Cops movie. Now, just yesterday, you were——

Secretary **Regan**. First of all, I have to say, this chart here is not reflective of inflation. If you did the same thing, starting over there in the post-World War II era with a pound of hamburger, you probably would come up with about the same slope. You have to adjust for inflation which was not caused by Ronald Reagan. Ronald Reagan has brought inflation down.

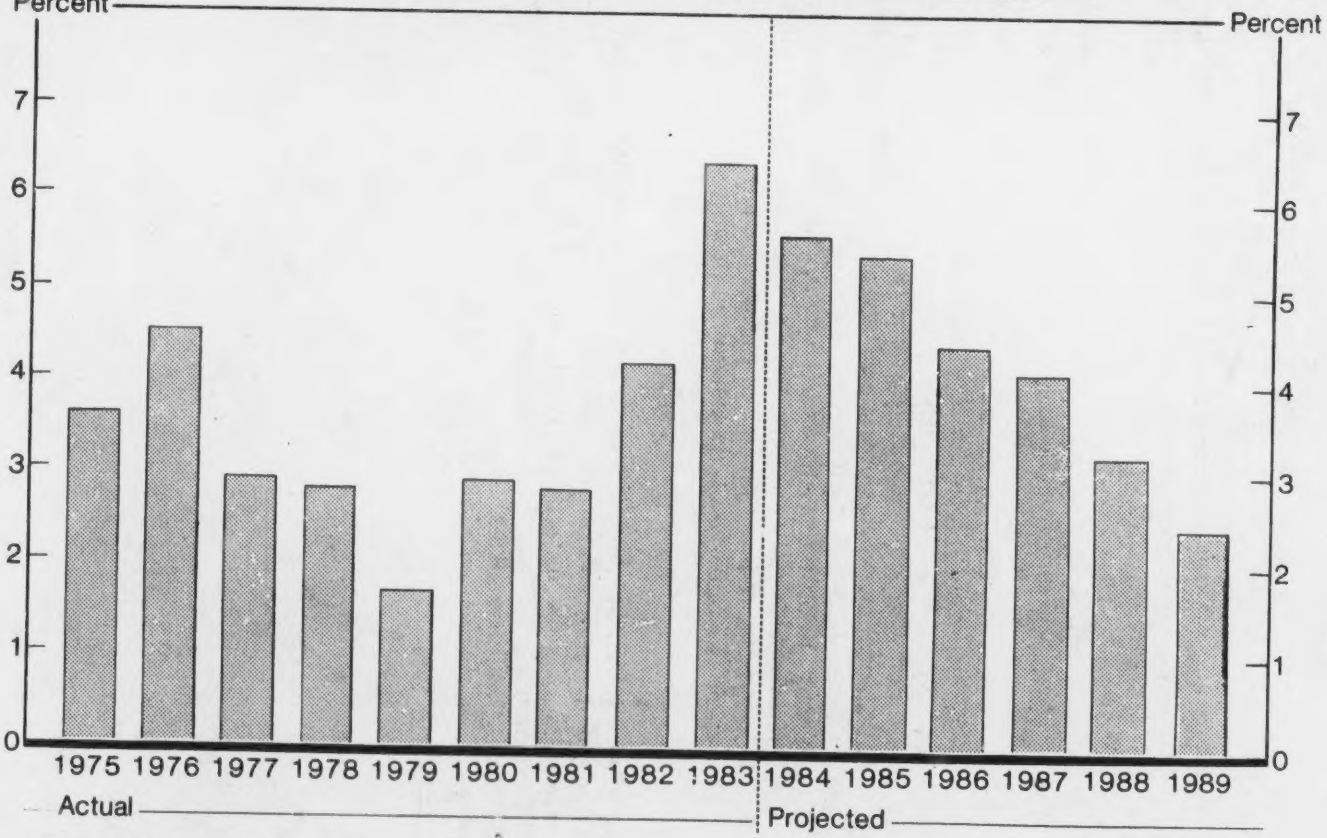
By the way, Senator, thanks for showing the President winning in 1984, because Reagan's deficits are going on out in the chart.

Senator **Riegle**. Well, I do not know whether he will win or not, but those are the ones you have asked for into the future.

DEFICITS AS PERCENT OF GNP

Secretary **Regan**. Anyway, Senator, this is the chart which is adjusted for inflation, or rather which show what our deficits are as a percentage of gross national product. Now, the percentage this year will be about 5.2. That, historically, is higher than it has been in the sixties and seventies. However, it will be coming down in that area on the projected side of the chart. It will come down to 2.3 percent.

BUDGET DEFICITS IN RELATION TO GNP*



*On and off budget as percent of fiscal year GNP.

Senator **Riegle**. No, no. I beg your pardon——

Secretary **Regan**. Well, that is what we are showing in the chart. We are showing that pattern of the deficit expressed as a percentage of GNP.

Also, I want to correct one thing you said. This is one economic adviser that is not in a panic. I am in no panic at all, and I do not think I am a Keystone Cop at all. I think I am very rational in what I am saying.

Senator **Riegle**. Well, then, how do we explain this—and first of all, I want to put into the record what you have just said in terms of the deficits as a percent of GNP is not correct. As a matter of fact, the all-time highest deficit in our history as a percent of GNP is 1983, 6.1 percent, under Reagan. The next highest, in our history, 1984, 5.2 percent, also in the Reagan administration; the third all-time highest, 1985 deficit projected, 4.6 percent, Reagan. I could go on.

ECONOMIC REPORT WELL-WRITTEN

But here is what is in this morning's Wall Street Journal. They are quoting you—I assume you said this, if they have the quote right. You are talking about the economic report that we were referring to earlier this morning, and you are quoted as saying "We think by and large it is well-written," Treasury Secretary Regan said in an interview. "We might not agree with every word of it, but by and large, we agree with its direction and its philosophy."

That is a direct quote. That is yesterday.

Today, you are here, and when we got into this, basically, you said there are eight pages of the report that are right, and there are 336 pages of the report that are wrong, and that you disavow, and you have been very blunt about it. You obviously feel very strongly about it. You said it with feeling, and I respect your feeling. I respect the fact that that is obviously what you believe.

But can you see, just even with yourself, the difficulty of reconciling what you are quoted in the paper today as saying, and what you are in fact telling us? I mean, these things seem to be at odds. I will let you respond to that in a minute, but let me give you a couple of other things.

BUDGET PICTURE CONFUSED

David Stockman was in here yesterday, talking about the budget. You were saying today that you support the budget. Well, he really gagged on it yesterday. We asked him to endorse the budget, and he almost had heart failure. I mean, he finally did, but it was very awkward for him to do so, because he obviously does not believe in it.

Then, yesterday, Dr. Feldstein somehow or another got into the White House Press Room. I do not know whether he came in through a window, unannounced, or what. You would think if he was going to have access to the White House Press Room, it would be with the approval of the President, that he would be speaking for the President. He spoke very candidly and at great length—and it has all been reported today; I am sure you have seen it, and we have read it—and he takes an entirely different view of all this—a different view than you have put forward—closer, I think, to Mr. Stockman's view, but it does not line up with Mr. Stockman's view. And the picture that one has is that everybody is riding off here in a different direction.

Now, I think the reason that this is happening is because it is awfully hard to somehow cope with the giant reality of these deficits that were not supposed to be here and which the President still wants to ignore or escape responsibility for. He keeps saying, "Well, that is the big-spending Congress," when in fact, we now know we have spent less than he has asked us to spend. So every dime that we have spent is money that he has requested us to spend.

So, I would like to say to you that it is a confused picture, and I would think that you are probably frustrated about it yourself, and it should not be a confused picture. It is not a professional way to assemble an economic viewpoint for an administration. And I think that in light of this, both the budget, which everybody is walking away from—you have not walked away from it today; you say you support it, but the other economic advisers are walking away from it—the economic report, which you basically have divided into two pieces, and you say you accept part, and you disavow the other part—you have been very forceful about it today—it seems to me that, you folks ought to go back and sit down with the President, take these documents, about which there is enormous controversy among yourselves, and sit down with the President and see if this cannot be worked out so that we have got some plan that everybody agrees on, that everybody can walk out the door and say, "This is the approach that we have for reducing these deficits, and this is the approach that we have for right now, this year, calendar 1984, and fiscal 1985."

It seems to me then we would have at least a sensible starting point. But I must say to you, Mr. Secretary, you really have not—and I do not just mean you, I mean the administration as a whole—given us a sensible starting point. You are all over the lot as a group.

I just do not think with the magnitude of this problem, as serious as it is, and the fact that we have to deal with it, and we should be dealing with it now, I do not think we can leave it that way. I think you have to go back, pull this thing together, and come back in here as a group and speak in some kind of a unified way, a unified presentation.

PRESIDENT WANTS THIS BUDGET

Secretary **Regan**. On what, Senator? What do we have to speak in a unified way on? You asked about the deficit. We are speaking in a unified way on the deficit. You heard from Stockman, you heard from Feldstein, you heard from Regan, all saying the same thing, that we should make a downpayment on this deficit and get on in a bipartisan and bicameral way to get the deficits down. We may disagree on the economic assumptions or on some phases of economics. When you go to an economic conference, you do not get unanimity among economists; you do not get unanimity on Wall Street. That is why you have buyers and sellers and brokers in the middle. You end up with various shades of opinion. As I told Senator Exon, a President is well served who hears various shades of opinion. He does not have to have unanimity of opinion. What he needs, though, is when he makes a decision that there be backing of his decision.

His decision is that he wants to go with this budget, and he wants further reductions made in it, a downpayment this year and more next year. That is what the President stands. for, and that is what I am backing. And that is what I am saying to you. We do have a unanimous opinion. I reject your notion that we are in disarray. We know what we want to do, if we can get the Congress to do it with us.

1-PERCENT BUDGET DISPARITY

Chairman Domenici. We have to go vote.

Mr. Secretary, one thing, we have not heard from Dr. Feldstein. We will hear him this afternoon. This committee has not heard from him, but we will.

Let me correct in the record only the semantics of your statement with reference to expenditures. My statement yesterday was prospective from 1984 through 1987. The President's submission and the numbers in the budget resolution would show that the President requests more money over that 5 years than the congressional budget resolution——

Secretary Regan. Oh, you are not talking about 1981 to 1984. I thought that was what the Senator had said. That was my understanding of it, and I was going to go back and check the record. I could not believe what I was hearing, but I accepted what the Senator said.

Chairman Domenici. No. Although it is not that much different in this first 4 years, there is a 1-percent disparity, not 1 percent of GNP. There is a 1-percent budget disparity.

Senator Riegle. But Mr. Chairman, unless I misheard yesterday, starting with 1982, the 3-year total from 1982 to 1984, that President Reagan had requested $2.74 trillion that the Congress had, in fact, only allowed $2.71 trillion—a difference of about $30 billion.

Chairman Domenici. You heard wrong, and the record will reflect that.

Senator Riegle. Well, what——

Chairman Domenici. That is 1985, 1986, and 1987, as projected in that budget and in our 1984 budget resolution.

Senator Riegle. Well, are you saying, then, that the totals were not presented yesterday for any earlier period?

Chairman Domenici. I do not know. I did not do it. I had to leave. But somebody might have for the earlier period. I did not.

CONGRESS HAS SPENT LESS

Senator Riegle. Well, let me just say to you, I thought they had been. But we have checked those numbers, and the same thing is true. The fact of the matter is—and let us put them in the record, because the numbers will tell their own story—the fact is that the Congress has spent less money since 1982 than the President himself has asked for.

Chairman **Domenici**. I would say, Mr. Secretary, you can go and check those, and you are at liberty to give them to us as you want to analyze them.

It is fair to qualify it in this respect. In two of the years and all of the outyears, we are going to spend less in defense than he asked for, and all of the lessening in defense will not be spent in domestic add-on's—almost all of it—so that the net is what we are referring to.

The President is correct in saying that the domestic is $40 billion higher over the last 3 years, but the combination is not higher, and that is what the numbers reflect.

I think that is what you were referring to.

Senator **Riegle**. Yes.

Chairman **Domenici**. Thank you very much.

[Whereupon, at 12:45 p.m., the committee was adjourned.]

AFTERNOON SESSION

The committee met, pursuant to notice, at 1:40 p.m., in room SD-608, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Kassebaum, Kasten, Quayle, Gorton, Chiles, Metzenbaum, Riegle, and Exon.

Staff present: Stephen Bell, staff director; and Gail Fosler, chief economist.

For the minority: Richard N. Brandon, staff director; and Garry Schinasi, senior economist for macroeconomics and fiscal policy.

Chairman **Domenici**. The committee will come to order.

Dr. Feldstein, let me clear up something that happened this morning, that might lead us all to some really irrelevant lines of questioning this afternoon. To avoid this, let me first ask you if you are aware of the fact that the Secretary of the Treasury said that we should take your economic report and throw it in the trash?

Dr. **Feldstein**. I suppose that was just a throwaway line of the Secretary's. [Laughter.]

Chairman **Domenici**. Well, let me go further, then. In truth, Secretary Regan seemed to be saying that he did not agree with the report and what it contained.

How do you respond to that?

Dr. **Feldstein**. Senator, there have been differences about some technical questions, questions about how budget deficits affect interest rates, how interest rates and other things affect the value of the dollar. I suppose that is the kind of thing that the Secretary had in mind this morning.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman **Domenici**. Well, we will still have some questions, but let me make some brief opening remarks, and then, Senator Chiles, I will yield to you and to the Senators who are here for some quick opening remarks, and then we will hear your testimony.

It is always a pleasure to have you appear. I used to think that being a politician put one in the center of controversy, but as an economist, you have certainly had your share. We even have had a little bit of it here this morning, as I indicated.

For my part, I want to commend you for your honest efforts to put forward economic forecasts that are about as accurate as any, and economic policy recommendations that are clearly intended to be in the best interest of the country. I am not going to challenge that, and from what I heard this morning, I do not think any Senators here are going to challenge that.

NATION FACING SERIOUS BUDGET CRISIS

I appreciate your honesty and your candor in expressing your views. It is undeniable that this Nation faces a significant and extremely serious budget crisis. This morning, that point was established with Secretary Regan, that maybe not this year, maybe not next, but better economic analysts than I are going to have to pinpoint the date for reducing the deficits; I do not know the date. But the inevitable need to reduce budget deficits is something we all agree on.

You and the Secretary of the Treasury, and from what I can tell, almost every member of this committee including myself, are agreed. I listen with interest to all the economic debate. Some of those who are givinq advice believe that the deficits have disastrous consequences, not only in the future, but right now. Indeed, I have read articles that attribute all our economic problems to the deficit.

Fortunately, we do not have that many problems right now. But some economists say that everything good that we have now is going to go bad as a result of the deficit. Others argue fiercely that deficits have no effect the economy, no effect on inflation or interest rates. Indeed, some, as near as I can make out, argue that the budget deficits have no effect on the American economy whatsoever. These argue that there will be no immediate benefits to bringing the deficits down; in fact, they assert that actions to reduce budget deficits at this particular moment by raising taxes will have adverse consequences.

The role of this committee is not to decide who is right in this debate, but rather, what actions are prudent. We cannot arbitrate economic theory. Rather, we must make some economic policy. The fact is that there is a broad middle ground of agreement. Deficits of the magnitude that are predicted are now, with very little debate, beginning to be consensus. And the broad middle ground says that deficits of this magnitude must be brought down.

You agree. From what I gathered this morning, the Secretary of the Treasury agrees. I have heard the President many times say he agrees. However, there may be disagreement about how we are going to do it, or how this whole process works in the American economy. But I think there is agreement on what I have just described.

ACT IN STEADY AND CONSISTENT WAY

So we want to get on with our job. I am convinced that the job is to act, and act in a steady and consistent way, over a number of years, to bring the deficits down. From what I can tell, that is your position. I hope you will elaborate on it in your opening remarks and in questions and answers.

You may be a little more precise than some others as to when you think we ought to start, or why we ought to start now, rather than later. But I think generally, what I have just said puts you in the broad middle ground. I am pleased that you are with us again, and I commend you for supporting the downpayment theory and hope that you will be there with us to give us advice as we need it.

[The prepared statement of Chairman Domenici follows:]

PREPARED STATEMENT OF CHAIRMAN DOMENICI

WELCOME DR. FELDSTEIN. IT IS ALWAYS A PLEASURE TO HAVE YOU APPEAR BEFORE THIS COMMITTEE. I USED TO THINK THAT BEING A POLITICIAN PUT ONE IN THE CENTER OF CONTROVERSY. BUT, AS AN ECONOMIST, YOU HAVE CERTAINLY HAD YOUR SHARE AND WE HAD A LITTLE SAMPLE OF IT THIS MORNING.

FOR MY PART, I WANT TO COMMEND YOU FOR YOUR HONEST EFFORT TO PUT FORWARD ECONOMIC FORECASTS THAT ARE ABOUT AS ACCURATE AS ANY AND ECONOMIC POLICY RECOMMENDATIONS THAT ARE CLEARLY INTENDED TO BE IN THE BEST INTEREST OF THIS COUNTRY. I APPRECIATE YOUR HONESTY AND CANDOR IN EXPRESSING YOUR OWN VIEWS. BUT, LET ME SHARE WITH YOU FOR A FEW MINUTES HOW I SEE OUR PROBLEM.

IT IS UNDENIABLE THAT THIS NATION FACES A SERIOUS BUDGET CRISIS. I ESTABLISHED THIS POINT WITH SECRETARY REGAN THIS

MORNING. MAYBE NOT THIS YEAR, OR NEXT YEAR, MAYBE NOT EVEN THE YEAR AFTER. BETTER ECONOMIC ANALYSTS THAN I WILL HAVE TO PINPOINT THE DATE. BUT THE INEVITABLE NEED TO REDUCE BUDGET DEFICITS IS SOMETHING WE ALL CAN AGREE ON. YOU, SECRETARY REGAN, MYSELF, WE AGREE ON THIS POINT.

NOW, I LISTEN WITH GREAT INTEREST TO ALL THE ECONOMIC DEBATE. SOME ECONOMISTS BELIEVE THAT THESE DEFICITS HAVE DISASTERIOUS CONSEQUENCES -- NOT ONLY IN THE FUTURE, BUT RIGHT NOW. INDEED, I HAVE READ ARTICLES THAT ATTRIBUTE ALL OUR ECONOMIC PROBLEMS TO THE DEFICIT. FORTUNATELY, WE DON'T HAVE THAT MANY RIGHT NOW -- BUT THESE ECONOMISTS SAY THAT ALL THAT WE DO HAVE ARE THE RESULT OF THE DEFICIT.

OTHERS ARGUE FIERCELY THAT DEFICITS HAVE NO EFFECT ON THE ECONOMY, NO EFFECT ON INFLATION OR INTEREST RATES. INDEED, SOME ECONOMISTS, AS NEAR AS I CAN MAKE OUT, ARGUE THAT FEDERAL BUDGET DEFICITS HAVE NO EFFECT ON THE AMERICAN ECONOMY WHATSOEVER. THESE ECONOMISTS ARGUE THAT THERE WILL BE

NO IMMEDIATE BENEFITS TO BRING THE DEFICITS DOWN. IN FACT, ACTIONS TO REDUCE BUDGET DEFICITS NOW BY RAISING TAXES WILL HAVE ONLY ADVERSE CONSEQUENCES.

THE ROLE OF THIS COMMITTEE IS NOT TO DECIDE WHO IS RIGHT IN THE DEBATE -- BUT RATHER, WHAT ACTIONS ARE PRUDENT. WE CANNOT ARBITRATE ECONOMIC THEORY, WE MUST MAKE ECONOMIC POLICY.

THE FACT IS THAT THERE IS A BROAD MIDDLE GROUND OF AGREEMENT. DEFICITS OF THE MAGNITUDE WE FORESEE CANNOT EXIST INDEFINATELY. THEY MUST BE BROUGHT DOWN. YOU AGREE, SECRETARY REGAN AGREES. THE PRESIDENT AGREES. THERE MAY BE DISAGREEMENTS ON HOW THIS WHOLE ECONOMIC PROCESS WORKS; BUT THERE ARE NO DISAGREEMENTS ON OUR BASIC GOAL.

SO WE CAN GET ON WITH OUR JOB. I AM CONVINCED THAT JOB IS TO ACT, AND ACT IN A STEADY AND CONSISTENT WAY, OVER MANY YEARS TO BRING THESE BUDGET DEFICITS DOWN. AS I INDICATED IN MY STATEMENT TO MR. STOCKMAN, MANY PEOPLE IN AMERICA TODAY BELIEVE OUR BUDGET DEFICIT ARE THE RESULT OF OVERSPENDING ON

DEFENSE. OTHERS BELIEVE OUR BUDGET DEFICITS ARE THE RESULT OF THE THREE YEAR TAX CUTS IN THE 1981 TAX BILL.

I SAY, THE MOST IMPORTANT CAUSE OF THESE BUDGET DEFICITS IS ECONOMIC -- THAT IS, THE UNPRECEDENT DECLINE IN INFLATION AND ECONOMIC GROWTH OVER ALMOST TWO YEARS, ACCOMPANIED BY HIGH INTEREST RATES THAT HAVE CAUSED THE INTEREST COSTS TO THE FEDERAL GOVERNMENT TO DOUBLE IN JUST FIVE YEARS. WE WILL NOT SOLVE THAT PROBLEM, THAT ECONOMIC PROBLEM, THIS YEAR OR NEXT YEAR. IT WILL TAKE TIME AND DEDICATION.

AND, FRANKLY, I AM NOT SURE HOW WE ARE EVER GOING TO SOLVE THE INTEREST PROBLEM. A VERY LARGE PART OF THE RISE IN THE SO CALLED STRUCTURAL DEFICIT IS DUE TO INTEREST COSTS. EVEN IF WE BRING THE DEFICIT DOWN WITH POLICY ACTIONS, I AM NOT SURE HOW WE ARE EVER GOING TO TURN THE INTEREST FUNCTION AROUND.

BUT IF WE CONCENTRATE ON THE IMMENSITY OF THE PROBLEM WE MIGHT NOT EVEN GET STARTED. INSTEAD, I THINK WE SHOULD BE

GRATEFUL THAT THE VERY STRONG ECONOMY WE HAVE RIGHT NOW GIVES US A WINDOW OF OPPORTUNITY AND THE PRESIDENT OF THIS COUNTRY HAS TAKEN THE LEAD IN WORKING WITH US TO MOVE FORWARD.

I BELIEVE WE WILL ACT -- POSSIBLY ON A LARGER PACKAGE THAN THE PRESIDENT HAS REQUESTED INITIALLY. I AM ENCOURAGED BY THE BIPARTISAN INTEREST AND SUPPORT THAT I WITNESS IN THIS COMMITTEE AND AMONG MY COLLEAGUES OF BOTH PARTIES IN THE SENATE. WE HAVE A LEGISLATIVE VEHICLE ALREADY IN BOTH HOUSES. I SAY TO YOU DR. FELDSTEIN, WE ARE READY TO GO.

NOW, DR. FELDSTEIN, WE WILL HAVE AN OPENING REMARK FROM SENATOR CHILES AND THEN TURN TO YOUR TESTIMONY.

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Chairman **Domenici**. Senator Chiles?

OPENING STATEMENT OF SENATOR CHILES

Senator **Chiles**. Thank you, Mr. Chairman.

Dr. Feldstein, we are glad to have you with us today. After what has been going the last few months, you are probably a little surprised that you are with us.

Every time I hear what you have to say, it reminds me a little bit about the ancient story of Cassandra. She had the gift of prophecy, but no one would listen. I think it is high time that people not only listened, but also heeded your advice. We know there has been a real tussle inside the administration as to whether the deficit can be cut to manageable levels with spending cuts alone, and we know what your advice has been on that.

SPENDING CUTS ALONE WILL NOT REDUCE DEFICITS

Like most of the other people here, I have read the reports describing in your economic memo to the President, so there is no need to go into details. But essentially, I think you have told him that deficits could not come down with spending cuts alone, and that we cannot wait to enact strong deficit reducing measures.

We on this committee, I think, certainly agree on that. You also said that the damage from the deficit would be a lot worse than any discomfort from at least temporary tax increases. That seems to be the core of the whole dilemma that we are in about revenue. It is not a question of who is for taxes—none of us are—but rather, that we are all against deficits, and how do we collectively try to bring them down.

I think the only reason the tax issue is before us at all is because the White House has thus far refused to include revenues in the budget package at a time when independent analyses have all agreed that that was necessary.

When Secretary Regan was here this morning, we heard that he disagrees with the council's report. When I look through the report of the President, a number of things jump out at me from the economic report and the council's report. One thing that jumps the highest is the table that you had, showing that in 1989, we could have a $187 billion deficit, and all of it structural.

This assumes that economic growth has reached full employment, that we have canceled out the cyclical deficit. And, as bad as those figures are in your report, the CBO has estimated those as high as $300 billion by the decade's end. And it is that structural deficit that concerns me. First of all the existing deficits are not likely to give us the kind of economic growth that the President predicts. So we could and probably will have a deficit larger than the $197 billion, and that prospect has to make me suspicious of the economic assumptions in the budget.

Second, by the end of 1985, we could be approaching the end of the typical 3-year recovery and if at that time we were to follow conventional steps and stimulate the economy to head off another recession, we would have to do it on top of a deficit that is already near $200 billion. That is a very dismal prospect.

LAST HALF OF DECADE COULD BE AWFUL MESS

Unless we take serious steps now to avoid it, I am afraid that the last half of this decade could be an awful mess. The evidence of trouble ahead is all around us. Just yesterday, you estimated the dollar is overvalued by 32 percent, and the major reason for that just has to be clear—the big Federal deficit.

Doctor, I am not going to occupy a lot of time with opening remarks, but we are interested in your views of what a budget package should look like, how much we need in spending restraints, and how much we need in revenues, and how soon we need them, and can we realistically impose further spending restraint on the domestic side, and how should we contain the growth of defense spending. Those are certainly the essential questions for any deficit debate, and I look forward to your views.

Thank you, Mr. Chairman.

Chairman **DOMENICI**. Senator Gorton?

OPENING STATEMENT OF SENATOR GORTON

Senator **GORTON**. Thank you, Mr. Chairman.

Dr. Feldstein, I would like to start by expressing to you publicly what I have done privately, a respect for the wisdom and courage which you have shown during your time here in Washington, D.C. It may have been a more eventful time than you had expected when you accepted this appointment.

I may also reflect that you have led me to consider the nature of the advice which any President gets and to state that I do not regard it as a disadvantage that there are public disagreements among Presidential advisors. We may not have had a President since Franklin Roosevelt who gloried in that, who enjoyed watching the debate among his advisors, but from my point of view, it is healthy. It is healthy for the President, it is healthy for the Congress, and it is healthy for the people of the United States, to see to it that there is not just simply one monolithic direction. And clearly, you have, sometimes when you may not have preferred to do so, added to the nature of that debate.

Two or three months ago, you were often, by some of your opponents in the administration, subjected to public ridicule, but it is likely that you may have the last laugh. I doubt that there is any individual in the United States who is more responsible for the President's proposal of a downpayment to this budget deficit last week than you. And even though many, if not all, of the members of this committee, whether Republicans or Democrats, feel that that downpayment is very modest, and would like to aim for a more significant attempt to reduce budget deficits this year, this nevertheless represents a major step forward to change the focus of the debate and is very, very healthy for the country. And for that, you deserve a great deal of thanks, but we are looking for even more precise advice, counsel, and assistance, as we deal with a most important and almost intractable problem.

Thank you, Mr. Chairman.

Chairman DOMENICI. Senator Riegle?

Senator RIEGLE. Mr. Chairman, Senator Moynihan was here before I was.

Chairman DOMENICI. Senator Moynihan?

OPENING STATEMENT OF SENATOR MOYNIHAN

Senator MOYNIHAN. Dr. Feldstein, let me just continue in the spirit in which Senator Gorton spoke. This is the last economic report which you will bring to the Congress in this cycle of your career, and I would want you to know that it is the feeling of this committee—I cannot speak for it, but I do not know anyone who thinks otherwise—that it may very well be that you are leaving, when you leave Washington, with an economy in ruins, but let me say that you will leave with a reputation intact, and with a new dimension. You came here with a reputation for brilliance, and you leave with a reputation for brilliance and courage, and that is a rare combination and you have rarely performed in it.

We need your help, and we need your advice. We believe you—we do not believe you—we think you are right, and we think you have been right. If there is a difference in the committee, it has something to do with this. There are some of us—at least, there is this Senator—who thinks it is the nature of the present deficit, the crisis that we now face, that it was deliberately created, a crisis in the Federal fisc was created with the object of so reducing revenues that you would have to dismantle Government, and the long-range objective of greatly shrinking the size of Government would be achieved, out of the compulsion which the deficit would impose.

But then, as we have all learned, as our distinguished chairman has said, it turned out that there was not a line item in the budget called "Waste, Fraud and Abuse, $179 billion," which could be simply eliminated, and hence, with that, the problem solved; that there are reasons for most things in the budget, and if we cannot reduce them any more—and Mr. Stockman says we cannot reduce outlays any more—what should we do?

As you very carefully point out, the implications are worldwide and calamitous. We are going to lose a decade here. With the dollar at 32 percent overvalued, there is no way the American industry can compete at the level of efficiency, given an exchange rate the Government has created for it. The responses are already there in a protectionism that could turn its back on 50 years of progress in a policy of American Government. The prospect for a ruined decade are real, and we just need your help and advice.

But let me close by saying I want to repeat how much you have earned and won our respect.

Chairman **Domenici**. Senator Riegle?

OPENING STATEMENT OF SENATOR RIEGLE

Senator **Riegle**. Thank you, Mr. Chairman.

I, too, will be brief, but I want to associate myself with the personal reflections about you that Senator Moynihan has just made. I can recall when you were here for confirmation hearings in the Budget Committee. I asked some hard questions at that time. But I want to say that as I have watched you perform in the time that you have been in this job, I think the integrity of the work effort, the integrity of preserving your own independence of mind and thought, has been very impressive. I think it has served the country well, and so I would like to associate myself with those comments that Senator Moynihan made.

I would like to say one thing about the macroeconomic dilemma that I think we face here, because there is genuine alarm by those of us who follow these issues closely on this committee and other financial committees in the Congress, that we have built up such a massive accumulation of deficits, particularly in the last 3 years and the projection that those will continue on out for the next several years, that it is fair to say that the country's future really has been put at very great financial risk. And it looks to me as if we were to be hit with a recession sometime next year—and let us hope that does not happen—but if we were to have, say, a major recession sometime out in 1985, calendar 1985, and had we not really changed very much the deficit path we are on right now, it looks to me as if we could find ourselves with both the structural deficit and a much-enlarged cyclical deficit combined, taking us up over $300 billion a year deficits, and perhaps well above that. I mean, it is conceivable that they could widen out in that dimension, as a result of the new recession. And I do not think the world financial structure can take that. We tested it perhaps more than we should have last year, in terms of the difficulties that the world economy had in coping with that recession and holding itself together with the foreign debts and other problems.

So I am concerned about the possibility that unless we act in a very substantial way now to change these trendlines, that we may subject ourselves to risks further down the line of a size that we may not be able to manage. They just may be beyond us then; whereas today, if we were to act, we could do something to prevent that. And it seems to me that what I hear you saying in the comments that you have been making in different committee appearances and in response to press questions, is that you think it is both desirable and necessary to make some substantial deficit reductions now, that we should try to do that, and that it really is a critical national requirement. I think you are right, and I am prepared to work with you on a bipartisan basis.

But I would hope in the course of your comments, that you will give us a sense for what you see these future risks as being—not to be an alarmist, but so that we understand the dimension of the stakes if we should fail to act more responsibly now.

Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you.

Senator Exon?

OPENING STATEMENT OF SENATOR EXON

Senator EXON. Thank you very much, Mr. Chairman.

Dr. Feldstein, my colleagues have beaten me to the draw. I wanted to add my voice of support and respect that you have here. I followed your career very closely before you came here, and since you came here, and I must say that I have not always agreed with you, but you have never disappointed me, and I think there are few people that I could say that about, regardless of their political affiliation. So we appreciate your straightforwardness very, very much.

I think we are in a mess. I think you think we are in a fiscal mess. And I am not interested in fixing responsibility for that; I am interested in trying to work on a bipartisan basis to correct it. And I am just wondering maybe if I could lead you into discussion by looking to the future. In what year would you expect, as an economist, that we might see the next significant downturn in the economy—and I assume that I would have to put some parameters around that, what we would do. Let us, for the sake of opening discussion—if the budget before us were accepted, when do you think we might likely see the next significant downturn in the economy, which is certainly going to come some time, because we know from history.

Chairman DOMENICI. We are going to reserve the questions until it's time to ask questions, Senator.

Senator EXON. Oh, this is opening statements? I am sorry. I was late coming in.

Chairman DOMENICI. Yes. I was accommodating some who wanted to make opening statements.

Senator EXON. Then, let me say that I will ask the question a little bit later.

The foregoing remarks stand as stated.

Senator CHILES. Senator Exon is so surprised to be able to make an opening statement, that he is kind of confused. [Laughter.]

Senator **Exon**. I thought I would get in first for once.

Chairman **Domenici**. He also used all 5 minutes of his question time for an opening statement. [Laughter.]

In any event, we are going to let Senator Metzenbaum make his opening statement, and then we will get on with the witness, and then the questions.

Senator **Metzenbaum**. Dr. Feldstein, I know what my colleagues have said. If I were to join in the chorus, which I would be willing to do, I am afraid that you might get your termination notice from the administration before you had left the room.

The President has been ignoring you. The Treasury Secretary scorns you. I am worried that we might damn you with Democratic praise and create a problem for you as to remaining in your position. So I will hold my time for questions.

Chairman **Domenici**. Thank you.

Dr. Feldstein, please proceed.

STATEMENT OF DR. MARTIN FELDSTEIN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Dr. **Feldstein**. Thank you, Mr Chairman.

I am certainly pleased to appear before this committee and very pleased by the kind remarks that Senators on both sides of the aisle made.

The primary economic problem that faces this committee and the Congress is to reduce the budget deficit during the next several years in a way that does not harm the economy in either the short term or the more distant future.

Before I discuss the administration's proposal for dealing with the deficit, I want to comment on the recent experience in controlling Federal Government spending.

Between 1960 and 1980, Government outlays on nondefense programs doubled, rising from 7.5 percent of GNP in 1960 to 15.1 percent of GNP in 1980. The rise in social security benefits and the introduction of medicare accounted for slightly less than half of this 7.6 percentage point increase. The remaining 4.2 percentage point rise reflects increases in a very wide range of programs from means-tested entitlements to the operation of individual Government agencies.

GOVERNMENT SPENDING HAS REMARKABLE REVOLUTION

During the past 3 years, there has been a remarkable revolution in Government spending. Social security benefits are now at least temporarily taking a decreasing share of GNP. All domestic spending other than social security and medicare has already declined significantly as a share of GNP and is expected to decline further in the coming years.

There is a table in the testimony, table 1,[1] that presents Federal Government outlays and receipts as percentages of GNP in fiscal years 1960, 1970, and the 1980's. The values for 1984 through 1989 reflect estimated current service levels for all of the domestic programs and last year's budget proposal for defense, and the economic assumptions with respect to real growth and interest rates used in the administration's budget calculations.

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[1] See p. 250.

Line 5 of this table shows that Government spending on all nondefense activities except social security and medicare took 9.3 percent of GNP in 1980. In the current fiscal year, that share is down to 7.5 percent of GNP, a decline of one-sixth.

Between 1980 and the current fiscal years, real spending on all nondefense activities except social security and medicare will have fallen by 12.6 percent. That is absolutely unprecedented. In the 5 preceding 4-year periods between 1960 and 1980, this real spending rose by amounts ranging from 11 percent to 38 percent.

If the current services level of these activities is maintained, this domestic spending share will be down to 6.7 percent of GNP by the 1986 fiscal year and thus back to the same GNP share as the late 1960's. This decline as a percent of GNP means that total spending on these activities will be $250 billion less in the 3 fiscal years from 1984 through 1986 than it would have been if 1980's GNP share had continued.

SUSTAINED DEFICITS ARE SERIOUS PROBLEM TO ECONOMY

Despite the progress that has been achieved in setting the domestic outlay share of GNP on a declining path, more needs to be done. The administration's economic projections imply that the budget deficit will remain roughly $200 billion a year for the rest of the decade unless there is legislative action to reduce spending or raise revenue. These deficits would occur even with the administration's economic forecast of strong growth and declining interest rates. If real growth is slower, and interest rates do not decline, the deficits could be substantially greater.

Sustained deficits of $200 billion a year—more than 4 percent of GNP—would be a serious problem for the American economy. It would reduce capital accumulation and long-term growth. It would cause the annual burden of financing the national debt to rise by as much as $100 billion a year by the end of the decade. And it would cause a lopsided recovery that is likely to be more fragile, slower-paced, and more inflationary than a balanced recovery.

In last year's budget, the administration proposed an appropriate deficit reduction program that would have begun with small reductions in the deficits of 1984 and 1985 but that would have reduced the 1986 deficit by 45 percent and cut the 1988 deficit to only 1.6 percent of GNP. The administration's program called for a balance of spending cuts, entitlement reforms and a contingent tax increase. As you know, the year ended without any legislative progress.

DEFICITS BEING DEALT WITH BY TWO-STAGE APPROACH

It is widely agreed that in this election year, it is not going to be possible to enact legislation that can eliminate the budget deficit by the end of the decade. The administration is therefore taking a two-stage approach to dealing with the prospective budget deficits.

The President has called upon the leaders of the Congress to establish a bipartisan group to work with the administration to de velop a downpayment package that will reduce the deficit by about $100 billion over the next 3 fiscal years.

Everything is negotiable. It should be possible to achieve such reductions by a combination of specific spending reductions and revenue increases that can command a widespread consensus.

I hope very much that these negotiations will be successful and that Congress will enact such a deficit reduction package during the next few months. Such legislation would give renewed confidence to the financial markets—and indeed, to the American people as a whole—that the projected deficits can be controlled and eventually eliminated. The result should be a stronger economy in 1984 and 1985.

It is really important that last year's stalemate not be repeated this year. The budget negotiations should proceed quickly and legislation should be enacted as soon as possible.

A downpayment package is, of course, just a first step. When Congress returns in 1985, it will be necessary to take additional measures that will have a larger impact on the deficits in fiscal year 1986 and beyond.

The future success of the American economy depends on the appropriateness of our Nation's fiscal and monetary policies. The administration's projection of sound growth with declining inflation and interest rates is based on the premise that appropriate monetary and fiscal policies are pursued during the coming years.

DECLINE EXPECTED IN GROWTH OF MONETARY AGGREGATES

More specifically, the growth of the monetary aggregates is expected to decline over the next several years except for adjustments to compensate for institutional changes or other persistent shifts of velocity. For fiscal policy, we assume that Congress will enact changes in spending and tax rules that reduce the deficit substantially over the next several years and put the budget on its way to balance.

With these assumptions about monetary and fiscal policy, we project real growth at an average rate of 4 percent from the final quarter of 1983 to the final quarter of 1989. We project that the inflation rate, as measured by changes in the GNP deflator, will rise temporarily to 5 percent in 1984 and will then fall gradually to 3.5 percent by 1989. With declining inflation, appropriate monetary policy, and shrinking budget deficits, interest rates should decline in the years ahead.

The forecasts assume that the Treasury bill rate will decline from the current level of about 9 percent to 5 percent in 1989.

A more complete discussion of our forecast and its underlying assumptions is presented on page 8[1] to the end of this testimony, but I will not read that to you today.

Of course, inappropriate monetary policies or a failure to agree on a deficit reduction downpayment package now and a more substantial program of deficit reductions in 1985 would leave the economy with very much less satisfactory economic prospects in the years ahead. An excessively tight monetary policy could cause an economic downturn, while an excessively easy monetary policy could cause a rise in inflation.

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[1] See p. 255.

Failure to reduce the deficits adequately would cause an unbalanced recovery that would likely make expansion slower, more fragile, and accompanied by a higher rate of inflation.

In conclusion, I want to emphasize the importance of the bipartisan negotiations on the budget deficit. If these negotiations are successful, we will have achieved a down payment not only on deficit reduction, but also a downpayment on securing a healthy and prosperous economic future.

Thank you, Mr. Chairman.

[The prepared statement of Dr. Feldstein follows:]

The Budget Deficit and Government Spending

by

Martin Feldstein

Thank you, Mr. Chairman. I am very pleased to appear again before this distinguished Committee.

The primary economic problem that faces this Committee and the Congress is to reduce the budget deficit during the next several years in a way that does not harm the economy in either the short term or the more distant future. Before I discuss the Administration's proposals for dealing with the deficit, I want to comment on the recent experience in controlling Federal government spending.

Government Spending

Between 1960 and 1980, government outlays on nondefense programs doubled, rising from 7.5 percent of GNP in 1960 to 15.1 percent of GNP in 1980. The rise in Social Security benefits and the introduction of Medicare accounted for slightly less than half of this 7.6 percentage point increase. The remaining 4.2 percentage point rise reflects increases in a very wide range of programs from means tested entitlements to the operation of individual government agencies.

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*Chairman, Council of Economic Advisers. This testimony was presented to the Senate Budget Committee on February 3, 1984.

During the past three years, there has been a remarkable revolution in government spending. Social Security benefits are now at least temporarily taking a decreasing share of GNP. All domestic spending other than Social Security and Medicare has already declined significantly as a share of GNP and is expected to decline further in the coming years.

Table 1 presents Federal government outlays and receipts as percentages of GNP in fiscal years 1960, 1970, and 1980 through 1989. The values for 1984 through 1989 reflect estimated current services levels for all domestic programs, the Administration's FY 1984 budget proposal for defense, and the economic assumptions with respect to real growth and interest rates used in the Administration's current budget calculations.

Line 5 of this table shows that government spending on all nondefense activities except Social Security and Medicare took 9.3 percent of GNP in 1980. In the current fiscal year, that share is down to 7.5 percent of GNP, a decline of one-sixth.

Between 1980 and the current fiscal years, real spending on all nondefense activities except Social Security and Medicare will have fallen by 12.6 percent (see line 5 of Table 2). This is absolutely unprecedented; in the five preceding four-year periods between 1960 and 1980, this real spending rose by amounts ranging from 11 percent to 38 percent.

If the current services level of these activities is maintained, this domestic spending share will be down to 6.7

Table 1

Budget Receipts and Outlays
Percents of GNP
(Fiscal Years)

	Actual						Current Services						Policy
	1960	1970	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1989
1. Total Outlays	18.5	20.2	22.4	22.8	23.8	24.7	24.0	24.3	24.1	23.8	23.4	23.0	22.1
2. National Defense	9.7	8.4	5.2	5.5	6.1	6.5	6.7	7.3	7.6	7.7	7.7	7.8	7.6
3. Net Interest	1.4	1.5	2.0	2.4	2.8	2.8	3.0	3.0	3.0	3.0	2.8	2.6	2.4
4. Other	7.5	10.3	15.1	15.0	15.0	15.4	14.3	14.0	13.4	13.1	12.9	12.6	12.1
5. Non-OASDHI	5.1	6.5	9.3	8.8	8.4	8.4	7.5	7.2	6.7	6.4	6.2	5.8	5.5
6. OASDHI	2.3	3.8	5.8	6.2	6.6	6.9	6.8	6.7	6.7	6.7	6.7	6.7	6.6
7. Social Security	2.3	3.1	4.6	4.8	5.1	5.3	5.0	4.9	4.8	4.8	4.7	4.7	4.6
8. Medicare	0.0	0.6	1.2	1.4	1.5	1.6	1.7	1.8	1.9	1.9	2.0	2.1	1.9
9. Total Receipts	18.6	19.9	20.1	20.8	20.2	18.6	18.7	19.0	19.0	19.0	19.3	19.4	19.8
10. OASDHI	2.1	3.9	5.3	5.6	5.8	5.7	5.9	6.1	6.1	6.2	6.5	6.6	6.7
11. Other	16.4	16.0	14.8	15.2	14.4	12.9	12.9	12.9	12.9	12.9	12.9	12.8	13.1
12. Deficit	-0.1	0.3	2.3	2.0	3.6	6.1	5.3	5.3	5.1	4.8	4.1	3.6	2.3
13. GNP	97.9	968.0	2575.0	2882.0	3057.3	3228.0	3558.7	3890.1	4231.3	4589.3	4963.0	5340.0	5340.0

CEA

percent of GNP by FY 1986 and thus back to the same GNP share as the late 1960's. This decline as a percent of GNP means that total spending on these activities will be $250 billion less in the three fiscal years from 1984 through 1986 than it would have been if 1980's 9.3 percent GNP share had continued.

Budget Deficits

Despite the progress that has been achieved in setting the domestic outlays share of GNP on a declining path, more needs to be done. The Administration's economic projections imply that the budget deficit will remain roughly $200 billion a year for the rest of the decade unless there is legislative action to reduce spending or raise revenue. These deficits would occur even with the Administration's economic forecast of strong growth and declining interest rates. If real growth is slower and interest rates do not decline, the deficits could be substantially greater.

Sustained deficits of $200 billion a year -- more than 4 percent of GNP -- would be a serious problem for the American economy. It would reduce capital accumulation and long-term growth. It would cause the annual burden of financing the national debt to rise by as much as $100 billion a year by the end of the decade. And it would cause a lopsided recovery that is likely to be more fragile, slower paced, and more inflationary than a balanced recovery.

In last year's budget, the Administration proposed an appropriate deficit reduction program that would have begun with small reductions in the deficits of 1984 and 1985 but that would have reduced the 1986 deficit by 45 percent and cut the 1988 deficit to only 1.6 percent of GNP. The Administration's program called for a balance of spending cuts, entitlement reforms and a contingent tax increase. As you know, the year ended without any legislative progress.

It is widely agreed that, in this election year, it is not possible to enact legislation that can eliminate the budget deficit by the end of the decade. The Administration is therefore taking a two-stage approach to dealing with the prospective budget deficits.

The President has called upon the leaders of the Congress to establish a bipartisan group to work with the Administration to develop a downpayment package that will reduce the deficit by about $100 billion over the next three fiscal years. Everything is negotiable. It should be possible to achieve such reductions by a combination of specific spending reductions and revenue increases that can command a widespread consensus.

I hope very much that these negotiations will be successful and that Congress will enact such a deficit reduction package during the next few months. Such legislation would give renewed confidence to the financial markets -- and indeed to the American people as a whole -- that the projected deficits can be controlled and eventually eliminated. The result should be a stronger economy in 1984 and 1985.

It is important that last year's stalemate not be repeated this year. The budget negotiations should proceed quickly and legislation should be enacted as soon as possible.

A downpayment package is, of course, just the first step. When Congress returns in 1985, it will be necessary to take additional measures that will have a larger impact on the deficits in fiscal year 1986 and beyond.

The future success of the American economy depends on the appropriateness of our nation's fiscal and monetary policies. The Administration's projection of sound growth with declining inflation and interest rates is based on the premise that appropriate monetary and fiscal policies are pursued during the coming years. More specifically, the growth of the monetary aggregates is expected to decline over the next several years except for adjustments to compensate for institutional changes or other persistent shifts of velocity. For fiscal policy, we assume that Congress will enact changes in spending and tax rules that reduce the deficit substantially over the next several years and put the budget on its way to balance.

With these assumptions about monetary and fiscal policy, we project real growth at an average rate of 4.0 percent from the final quarter of 1983 to the final quarter of 1989. We project that the inflation rate, as measured by changes in the GNP deflator, will rise temporarily to 5.0 percent in 1984 and will then fall gradually to 3.5 percent by 1989. With declining inflation, appropriate monetary policy, and shrinking budget deficits, interest rates should decline in the years ahead. The forecasts assume that the Treasury bill rate will decline from the current level of about 9 percent to 5.0 percent in 1989. A more complete discussion of the Administration's forecast is presented in the attachment to this testimony.

Of course, inappropriate monetary policies or a failure to agree on a deficit reduction downpayment package now and a more substantial program of deficit reductions in 1985 would leave the economy with very much less satisfactory economic prospects for the years ahead. An excessively tight monetary policy could cause an economic downturn while an excessively easy monetary policy would cause a rise in inflation. Failure to reduce the deficits adequately would cause an unbalanced recovery that would likely make expansion slower, more fragile, and accompanied by a high rate of inflation.

In conclusion, I want to emphasize the importance of the bipartisan negotiations on the budget deficit. If these negotiations are successful, we will have achieved a downpayment not only on deficit reduction but also a downpayment on securing a healthy and prosperous economic future.

The Economic Outlook for 1984-89

The Administration's new economic projections for 1984 through 1989 are shown in Tables 2 and 3. Our current economic assumptions repeat last year's projections that the economy will experience strong growth with declining inflation over the next six years.

Real GNP is projected to grow 4.5 percent between the fourth quarter of 1983 and the fourth quarter of 1984. The inflation rate, as measured by the GNP deflator, is projected to be 5.0 percent over the same period. This coincides with the Administration's projections in the midsession review prepared in June of last year, and with last February's inflation projection. It represents an increase of one-half percent from the growth rate projected in the outlook that I presented here last February.

For 1985 through 1988, real GNP is projected to grow at 4.0 percent annually, the same growth rate that we projected for these four years in our outlook of a year ago. We assume that capacity is approached at the end of this period and that real GNP in 1989 is then projected to grow at 3.75 percent.

These growth rates are associated with a substantially improved outlook for unemployment in recent months, the average unemployment rate for 1984 is now projected to be 7.8 percent. The current projection of the unemployment rate indicates that unemployment will decline gradually to a rate of 5.7 percent in 1989. This reflects the completion of the

Table 2

Six Year Economic Assumptions: Growth Rates

	Real GNP Growth Rate	
	4th Quarter to 4th Quarter	Year to Year
1984	4.5	5.3
1985	4.0	4.1
1986	4.0	4.0
1987	4.0	4.0
1988	4.0	4.0
1989	3.7	3.9

	Inflation GNP Deflator	
	4th Quarter to 4th Quarter	Year to Year
1984	5.0	4.5
1985	4.7	4.8
1986	4.4	4.5
1987	4.1	4.2
1988	3.8	3.9
1989	3.5	3.6

	Nominal GNP Growth Rate	
	4th Quarter to 4th Quarter	Year to Year
1984	9.7	10.0
1985	8.9	9.1
1986	8.6	8.7
1987	8.3	8.4
1988	8.0	8.1
1989	7.4	7.6

Table 3

Six Year Economic Assumptions: Levels

	Real GNP Growth Rate (1972 dollars)		
	Calendar Year	Fourth Quarter	Fiscal Year
1984	1616.0	1641.3	1598.3
1985	1682.2	1707.0	1665.7
1986	1749.5	1775.3	1732.4
1987	1819.5	1846.3	1801.7
1988	1892.3	1920.2	1873.8
1989	1965.7	1992.3	1947.7

	GNP Deflator (1972 = 100)		
	Calendar Year	Fourth Quarter	Fiscal Year
1984	225.4	229.5	222.7
1985	236.2	240.3	233.5
1986	246.9	250.9	244.2
1987	257.3	261.1	254.7
1988	267.4	271.1	264.9
1989	277.0	280.6	274.6

	Nominal GNP Growth Rate		
	Calendar Year	Fourth Quarter	Fiscal Year
1984	3642.4	3766.8	3558.9
1985	3973.8	4101.6	3890.1
1986	4319.2	4453.5	4231.3
1987	4681.2	4821.4	4589.3
1988	5059.0	5205.1	4963.0
1989	5444.9	5589.4	5348.8

	Total Unemployment Rate		91-Day Treasury Bill	
	Annual Average	Final Quarter	Annual Average	Final Quarter
1984	7.8	7.7	8.5	8.3
1985	7.6	7.5	7.7	7.5
1986	7.3	7.2	7.1	6.9
1987	6.8	6.5	6.2	6.0
1988	6.1	5.8	5.5	5.3
1989	5.7	5.7	5.0	5.0

cyclical recovery and the effects of the Administration's enacted and proposed employment policies in reducing the structural unemployment rate.

Another unexpectedly favorable development in recent months has been the rapid decline in inflation. Inflation, as measured by the GNP deflator, has been less in 1983 than the 4.6 percent anticipated in the midsession review. Although we continue to project a 5.0 percent rise in the 1984 GNP deflator, the inflation rate is then projected to decline gradually but steadily to 3.5 percent by 1989.

The combination of falling inflation and declining budget deficits imply that nominal and real interest rates will also decline. Our projections assume that the interest rate on three-month Treasury bills declines from the current level of nearly 9.0 percent to 5.0 percent in 1989.

The Administration's projections for 1984 are very similar to the thinking of most private economists. The consensus of the 45 economists in the January 1984 survey indicated a real GNP growth rate of 4.4 percent from the fourth quarter of 1983 to the fourth quarter of 1984, almost identical to the Administration's projected 4.5 percent rate. Similarly, the Blue Chip consensus indicates a GNP deflator increase of 5.2 percent in 1984, also almost identical to the Administration's 5.0 percent rate of inflation.

Our projections for 1984 are consistent with the recent pace of economic activity, with the sizeable fiscal stimulus of an approximately $140 billion structural deficit, and with the expectation that the money supply will continue to grow enough to support nominal GNP growth of nearly 10 percent.

The Administration's economic assumptions for 1985 and beyond must be interpreted wih care because they are conceptually different from the type of forecast that private economists make and, presumably, from the forecasts of the Congressional Budget Office. There are two quite important differences.

Conditional Forecasts

First, our economic assumptions for 1985 through 1989 are based on the premise that legislative action will reduce budget deficits sharply in the years ahead. More specifically, in the current situation, this means that the bipartisan negotiations will be fruitful and will reduce the deficit by about $100 billion or more over the next few years. Of course, even if the negotiations are fully successful, the future budget deficits would remain too large. The Congress must therefore also enact legislation that will be proposed in 1985 to slash deficits sharply before the end of the decade, moving the budget closer to balance. If such deficit reductions are not enacted, the interest rates are not likely to fall over the next five years as we have projected and growth of real GNP is likely to be slower than we have assumed.

Moreover, larger deficits might induce a monetary policy that raises the rate of inflation in the years ahead.

If there is legislative action to reduce future budget deficits sharply as we have assumed, the Administration's projected performance of the economy provides a plausible picture of our economic future. The Administration's projections imply that the average annual rate of growth of real GNP in the seven years from the business cycle trough in the final quarter of 1982 to the final quarter of 1989 will be 4.3 percent. By comparison, the first seven years after the previous business cycle troughs in all of the pastwar recessions (except the 1980 trough since we do not yet have seven years of experience) had average annual growth rates of 4.0 percent. The difference of 0.3 percent a year between our projections and previous experience is not large and it is certainly not unreasonable as a response to the improved monetary and fiscal policies that we assume for the remainder of the decade.

Most private forecasters currently project that deficits will be reduced after 1984 but not by as much as the Administration assumes. Many of these forecasters also believe that monetary policy will not be as conducive to noninflationary growth as we have assumed. Their forecasts point to lower growth of real GNP and higher inflation than the Administration's projections. More specifically, in the Blue Chip Survey of leading private forecasters, the projected level of real GNP in 1989 is 3.7 percent lower than the level projected by the Administration. This represents a difference of 0.6 percent as the average annual rate of growth between 1983 and 1989. With the same rate of inflation, the slower growth implies that the level of GNP in 1989 would be $203 billion less than the $5,445 billion projected by the Administration for that year.

The 5.0 percent rise in the GNP deflator that the Administration projects for 1984 is very close to the average of 5.2 percent projected by the private forecasters in the most recent (January 1984) Blue Chip Survey. After 1984, the Administration forecasts that the inflation rate will fall by 0.3 percent a year to 3.5 percent in 1989. Since the private forecasters do not currently anticipate sharply falling deficits and an anti-inflationary monetary policy, they project that the rate of increase of the GNP deflator will remain between 5 percent and 6 percent for the remainder of the decade.

Different assumptions about deficits and inflation account for the difference between the Administration's projected path of interest rates and the future interest rates that are now implied by the financial futures markets and the yields on securities of different maturities. Sharply falling deficits should reduce the real interest rate while declining inflation should shrink the inflation premium in the market interest rate. The Administration's projection of a 5.0 percent interest rate on 91-day Treasury bills in 1989 implies a real interest rate of 1.8 percent, a level that is actually higher than the 1.3 percent average real T-bill rate during the last thirty years. In contrast, the financial markets are currently less sanguine about the effects of deficits and inflation on interest rates. The Treasury bill futures market and the yield curve for Treasury securities implies that financial markets expect the interest rates on Treasury securities to rise over the next few years.

In summary, the difference between the Administration's economic projections and most private forecasts is basically due to conflicting assumptions about future fiscal and monetary policies rather than to any difference of opinions about the way that the economy operates. I believe that if most private economists accepted the premise of sharply declining deficits and a sound monetary policy, they would forecast more robust growth and lower inflation. Similarly, if we had to base our projections on the assumption that Congress would not enact this year's budget recommendations and a further major deficit reduction package in 1985 and that the Federal Reserve would not pursue a sound monetary policy over the coming years, we would be forced to project slower growth and rising inflation.

Long-Term Focus

The second important difference between the Administration's economic projections and private forecasts is that our strategy is to focus on the overall trend in real GNP and not to forecast year-to-year fluctuations. We forecast a four percent rate of growth of real GNP in each year from 1985 through 1988 even though we recognize that there will be some years in which real growth exceeds four percent and others in which it is less than four percent. We do not claim to have the ability to forecast these year-to-year oscillations in the future.

I would emphasize, as I did last year, that such year-to-year detail is unnecessary for the purpose of shaping the budget and guiding the evolution of government programs. If economic activity exceeds our projections in some future year, the resulting budget deficit in that year will be smaller than we forecast; conversely, if the economy is weaker than we project in some future year, that year's deficit will be larger. Such cyclical fluctuations in the deficit along the path toward budget balance are not inappropriate.

The experience of the past year has served to underline the inherent uncertainty of all economic forecasts. The extent to which the uncertainty of a forecast impairs its usefulness depends on the purpose for which the forecast is intended. A business that wants to use an economic forecast to plan its near-term production and inventories would need a forecast that provides quite accurate short-term detail. A government that is adjusting monetary and fiscal policies continuously in an attempt to prevent unwanted fluctuations in real GNP would also need more accurate forecasts than we believe are possible.

The primary purpose of the Administration's economic projections is to serve as a basis for long-term budget planning. We believe that the accuracy and nature of our projections are adequate to that task. The projections clearly imply that substantial legislative changes to reduce the deficit will be needed in future years if the budget is to be moved into balance or near balance before the end of the decade.

Chairman DOMENICI. Thank you very much. I am going to reserve my questions, so, Senator Gorton, you are first.

Senator GORTON. Thank you.

Dr. Feldstein, because of the rather contrary advice we had on this subject this morning, could you explain your views succinctly on the relationship between present budget deficits, the anticipation that they will continue or not continue, interest rates, and the value of the dollar vis-a-vis the currencies of our major trading partners?

ATTRACTIVENESS OF INVESTING IN THIS COUNTRY CREATES STRONG DOLLAR

Dr. FELDSTEIN. Yes. The principal reason—not the only reason, but I think the principal reason—why the dollar is so strong now in comparison to currencies of other industrial countries is the attractiveness of investing in this country, particularly the high, real, long-term interest rates.

Those high, real, long-term interest rates are primarily a reflection of the anticipation of large, continuing budget deficits in the future, of the fact that a large fraction of available savings will be absorbed by Government borrowing. That is not the only reason why we have a strong dollar, and it is not the only reason why we have a trade problem with the rest of the world, but it is certainly the primary one.

Senator GORTON. And I take it that that philosophy, that set of ideas, is central to your portion of the report about which we heard this morning, the President's Council of Economic Advisers?

Dr. FELDSTEIN. The second chapter of the report discusses the international setting of the American economy. We develop that idea and discuss the reasons for the trade deficit and the fact that it can be reversed if the dollar comes down.

Senator GORTON. Now, you may be the wrong person to whom I should direct this question. When I was here this morning, I did not have this morning's Wall Street Journal before me, but I see in a story in that newspaper, a quote from the Secretary of the Treasury, which I will read: "We might not agree with every word of it, but by and large, we agree with its direction and in its philosophy."

Do you have any idea what has happened between yesterday and this morning that would so drastically change the views of the Secretary of the Treasury?

Dr. **FELDSTEIN**. No, I do not, Senator. And I was not here this morning, so I am not quite certain what the Secretary actually said.

Senator **GORTON**. Well, he certainly did not agree with the views which you have expressed on these relationships between deficits, interest rates, and the value of the dollar.

Let me go on and ask whether or not you can advise us on your views of that relationship to any precise degree, and ask to that, a preliminary question.

PROJECTIONS OF INTEREST RATES DEPEND ON STRONG ATTACK ON DEFICITS

I believe that you have said that the projections of interest rates, and for that matter, rates of inflation and real growth in the economy, contained in the budget document rest on the proposition that there will be a strong and a successful attack on these deficits rather than simply a continuation of present policy; is that correct?

Dr. **FELDSTEIN**. Yes, that is correct.

Senator **GORTON**. And that if in fact, there is no such attack, if budget deficits are on the order of those projected by CBO, that interest rates and probably the rate of inflation would be markedly higher.

Dr. **FELDSTEIN**. I feel more strongly that interest rates would be higher, but yes. And I think there would be a risk that inflation rates would be harder to bring down, because of the pressure that high interest rates might put on the Federal Reserve to expand the monetary aggregates more rapidly than they otherwise would, leading us to more inflation.

Senator **GORTON**. Have you developed any kind of theory as to either the relationship—a precise relationship—between interest rates and deficits, or is it more likely to be related not so much to the absolute amount of the deficit but to perceptions as to whether they are going down or going up.

Dr. **FELDSTEIN**. No; I think it is the amount of the deficit in relation to savings in the country, and the extent to which the Government absorbs available private savings and force domestic investment to shrink back In order to shrink back domestic investment to the available amount of savings, interest rates have to rise.

There recently has been a reduction in investment that has been partially ameliorated by the inflow of capital from abroad. So the high real interest rates are doing two things—they are cutting back on interest-sensitive domestic demand, and they are also attracting very substantial amounts of capital to the United States. When that ceases to happen, when the dollar comes down and we no longer have the large inflow of capital, then domestic interest rates will rise even more.

Senator **GORTON**. With the indulgence of the chairman, one last question.

Chairman **Domenici**. Go ahead.

Senator **Gorton**. How much reduction in the deficit for fiscal year 1985 from simply an extension of current policy would you say is ncessary to have an impact on the order of lowering interest rates across the board by 1 percent?

Dr. **Feldstein**. There is no precise answer to that, but I would emphasize that what is more important than just a single year's reduction in the deficit is what people in financial markets expect to happen in the future. If they think it is a one-time deficit reduction, for just 1985, it will have very little impact on interest rates. If they think we are on a path that is going to bring the deficit down to a very small share of GNP by 1987 and 1988, then I think we could see a significant reduction in interest rates.

Senator **Gorton**. Thank you, Mr. Chairman.

Chairman **Domenici**. Senator Moynihan was next, but he has gone.

Senator Riegle?

FURTHER REDUCTIONS IN DEFICIT NEEDED

Senator **Riegle**. Dr. Feldstein, do you support the administration's budget proposal as it has been sent up here?

Dr. **Feldstein**. I do.

Senator **Riegle**. For fiscal 1985 and for the outyears?

Dr. **Feldstein**. I think I should be very clear that this budget proposal is just a baseline. The purpose of the negotiations is to go beyond it and get further reductions in the budget deficits for fiscal 1985 through 1987. There should be a clear understanding that this is just a first step, a downpayment, and that more will have to be done in calendar 1985.

Senator **Riegle**. If we pass the budget exactly as it has been sent to us, if we held a vote late this afternoon and we reported it out just exactly as it has come, I understand what you are saying, you accept it as a starting point to change it, but you would not want to see it passed as is?

Dr. **Feldstein**. I would be happy to see it passed as is, but I would like to see more done on top of that.

Senator **Riegle**. You think the deficits that are projected for fiscal 1984 and the outyears in the budget request are acceptable.

Dr. **Feldstein**. They are a starting point. I think that if Congress wanted to pass these this afternoon and then settle into the bipartisan negotiations and do more later that it would be acceptable. But you are asking my views on this budget, with no additional action to reduce deficits.

Senator **Riegle**. Yes; that is right.

Dr. **Feldstein**. I think that would be unfortunate. What we really want is to go beyond what is called for here and get further reductions in the deficit.

Senator **Riegle**. So in other words, the starting point, the budget proposal, if we were to adopt it just as it has been presented to us, you would find that unacceptable; you really do not want us to do that. You want us to take that as a starting point and whittle it down; is that not right?

Dr. **Feldstein**. I do not want to say that.

Senator **Riegle**. I know you do not want to say it, but I mean——

Dr. **Feldstein**. I want to say that I think we need to do more than what is called for in the budget. I think that is the President's position in suggesting the negotiations.

Senator **Riegle**. Well, if the budget document that has been presented to us, is too large, it is more than you think we prudently should agree to right now and you have made clear that you want to see us negotiate and try to work it down. If we took it as is, which means taking it in a form that is larger than it should be, what are the risks that would follow? What is it that concerns you about that?

MARKET NEEDS REASSURANCE OF LOWER DEFICITS

Dr. **Feldstein**. Let me be clear. If the Congress took it as is, it would be better than last year; we would have made some progress. We would have lower deficits than would otherwise be the case. But it would not be enough. As I said in my testimony, if we do not provide some reason, some reassurance to help the market believe that deficits are going to be coming down, we are likely to have higher interest rates than we otherwise would, and in the future, we will end up having slower growth than we otherwise could have.

So I think it is very important to build on the budget and get further reductions.

Senator **Riegle**. You are quoted as having said yesterday, quote, "The budget is not what we want to see happen in 1985."

Dr. **Feldstein**. But we want to see more than is in the budget. We want to go beyond the budget and get these negotiations to reduce the deficits even further.

Senator **Riegle**. You see, we have a terrible problem here, and it is not one of your creation, because you came late in the game. But we have had the most massive accumulation of deficits in the history of the country since the Reagan administration came to town. We have documented already in this committee yesterday and today, with David Stockman, and with Secretary Regan this morning, that on just the spending side, that since the day the Reagan administration arrived, Congress has actually spent less money than the President has asked us to spend.

So, yes, we have been on an enormous spending binge, and it has gotten us into deep trouble, but any misimpression that people have that somehow or another, that has been something that the Congress has done and that the President has not wanted us to do is just not true. In fact, he has asked us to spend even more than we have been willing to spend.

But the problem is that we are doubling the national debt here in a period of about 5 years. And frankly, we have never been in a situation like this before, and I do not think we can handle it. I do not see us, either the national economy or the world economy, having the strength to sustain the continued piling up of $200 billion deficits.

DEFICITS ABOVE $300 BILLION POSSIBLE

I asked you the question, posed it for you to consider at the outset. Let us assume not much is done; maybe we do not even get the downpayment, the so-called downpayment—I think, by the way, these deficits are a cancer on the American economy, and I think the downpayment is like a band-aid on the cancer—let us say we do not get it, and let us say we get into next year and a recession sets in, and we suddenly find that we are seeing the deficit widen out because of the fact that the economy is shutting down. Isn't it conceivable in the absence of strong action this year and the possibility of this hypothetical recession next year, that we could see deficits going above $300 billion?

Dr. **Feldstein**. I believe that is the estimate of the Congressional Budget Office, based on a less optimistic economic path and higher interest rates, and I think that is possible.

Senator **Riegle**. You think that is possible if——

Dr. **Feldstein**. I think it is possible if we do not get the kinds of things that the President has called for in the negotiations, and then a followup, second step in 1985.

Senator **Riegle**. What——

Chairman **Domenici**. Senator Riegle, Senator Chiles would like to ask a question because he must leave. Could we do that?

Senator **Riegle**. By all means.

Senator **Chiles**. I do not want to take any of your time, but is this a breaking point that I could ask a question?

Senator **Riegle**. I can come back to it, so let me yield to Senator Chiles.

Chairman **Domenici**. Go ahead.

HIGHER TAXES NOT NECESSARILY REQUIRED FOR EXPANDING AREAS

Senator **Chiles**. Dr. Feldstein, I like your approach of looking at spending as a percentage of GNP. It seems that with a stable tax structure, any part of the spending which grows faster than the GNP is going to either add to the deficit or will have to be paid for by taxes.

I would like to know if you could tell us, how much tax revenue do you think that we will need to pay for those parts of the budget—defense and medicare seem to be two parts that stand out now—which are increasing as a percent of GNP—and I assume there that we could be making cuts in either one of those areas, so I do not want to preclude you there. I am not just trying to say it has to be a tax. But do you have any number that you could give us in that area?

Dr. **Feldstein**. I am not sure that I understood the question. What you said was if we have some areas that are expanding, we have to pay for them somehow.

Senator **Chiles**. That is right.

Dr. **Feldstein**. That is certainly right. But of course, we can pay for them by shrinking other areas of spending. Over the next 5 years, although current services' projections, show increases for medicare and for other programs, and for defense as a percentage of GNP, total spending as a percentage of GNP is actually coming down.

Senator **Chiles**. Right.

Dr. **Feldstein**. So, we do not necessarily have to pay for them by higher taxes.

Senator **Chiles**. I understand that. I am combining that with the fact that we have made some pretty good cuts in those areas. It looks like there is more resistance, revisiting in our numbers the nondefense discretionary areas and going back and making further cuts. In other words, the easy money is gone from there. I think you recognize that, and certainly, Director Stockman seems to recognize that, that as a practical thing, it is going to be hard to get moneys there.

Dr. **Feldstein**. Yes, but what is it that you are asking, more specifically?

GAP OF 3.5 PERCENT OF GNP INTOLERABLE

Senator **Chiles**. I am just asking what will we have to do from a revenue base of around 19 percent—how far do you see us being able to close the gap, let us say, between spending and the revenue base, and where should we meet?

Dr. **Feldstein**. I do not have an answer for that, but you are right that if you look at where we will be if nothing is done, we will have outlays of 23 percent of GNP; we will have receipts at 19.4 percent of GNP, and we will have a 3.6 percent of GNP gap.

Senator **Chiles**. And we all say that is intolerable.

Dr. **Feldstein**. That is right. We cannot go on with that. So we have to make it up by either bringing down spending or bringing up revenue to close that gap.

Senator **Chiles**. Or a combination of the two.

Dr. **Feldstein**. Or a combination of the two.

Senator **Chiles**. But you do not have a——

Dr. **Feldstein**. I do not have any magic formula for how to strike that balance.

Senator **Chiles**. Thank you.

Senator **Riegle**. If I may, then, just pick up where we were——

Chairman **Domenici**. Sure.

CONTINUED STRUCTURAL DEFICIT IS THE BASIC PROBLEM

Senator **Riegle**. If we were to see a situation, then, where we did not take significant deficit reduction action this year, and we were hit with a recession in calendar 1985, and we saw the deficit, then, really widen out, because we would get a whole new cyclical component on top of what is already there, and we got up into the $300 billion deficit range, or even higher than that, I would like you to try to help us understand as an economist what the associated risks are to us. I think getting that clearly in mind is going to be what helps drive the question of whether we can work something out now. In other words, if you can help the Congress and the public understand what the risks are that we are running if we do not deal with this, then we are more apt to find a way to deal with it now.

Do you see what I am saying?

Dr. **Feldstein**. Yes, I see what you are saying. Of course, an enlarged deficit caused in part by a cyclical downturn would not be a structural deficit, and so it is not quite comparable to the numbers we have been talking about. To that extent, the enlarged deficit would not be doing as much damage as it would be doing if it were a structural deficit.

Senator RIEGLE. Could we handle it—can we absorb on top of what we have already seen——

Dr. FELDSTEIN. If we do not bring these deficits under control, if these negotiations fail, if the Congress cannot in 1985, when the election is behind us all, do some more dramatic things—yes, we can go forward, but it is not going to be the kind of healthy recovery that we would like.

The 1970's were a decade in which real hourly earnings did not rise. That is not the kind of decade we want. It was a decade in which inflation doubled, interest rates kept rising. We want to avoid that again, and that is why I think we have to bring down these deficits.

Senator RIEGLE. But I am trying to give you an opportunity, if you feel this is the case, to let us know how serious, say, a $300 billion deficit would be. And the feeling I get from you is that it is manageable, and that we can take it in stride, and that that is not something that should keep us awake worrying about.

Dr. FELDSTEIN. I am worried about the continuation, year after year, of deficits that absorb 4 percent or so of GNP.

Senator RIEGLE. I agree with you.

Dr. FELDSTEIN. If, in addition to that, you had a year or two in which there was a cyclical downturn, and the deficit rose to 5 or 6 percent of GNP, that would make things a little bit worse, but not appreciably so. The basic problem is the continued structural deficit and not the possibility of a cyclical deficit on top of it.

Senator RIEGLE. So, just to finish it, you are saying that even though we have had a pattern now of very high deficits—we are adding literally $1 trillion to the national debt over a relatively short period of time with the Reagan period here, and the momentum out of it. So you are saying that even though we have had that enormous pileup of debt, even if we had a downturn and had another $300 billion deficit tossed on top of that, that the cumulative effect of that over this period of time—not in the abstract, but this is the pattern that we have been going through—would still pose some kind of new and more serious and dangerous risks to us.

Dr. FELDSTEIN. I cannot distinguish between the risk of a $200 billion structural deficit in, say, 1988 and a $300 billion deficit in 1988, $100 billion of which is cyclical. I think they are both serious problems. And we just do not want to get ourselves in a situation where we are exposed to that risk. I think we want to start getting these deficits down now.

Senator RIEGLE. My time is up.

Chairman DOMENICI. Senator Kasten?

RATE OF GROWTH OF GOVERNMENT SPENDING HAS BEEN CUT

Senator KASTEN. Thank you, Mr. Chairman.

Last year the rate of growth of Government spending was roughly 11.5. Is that the number you are using, Marty?

Dr. **Feldstein**. This is from 1983 to 1984—the total outlays in 1983 including interest——

Senator **Kasten**. 1982 to 1983, I was thinking.

Dr. **Feldstein**. 1982 to 1983. 1982 was $728 billion; 1983 was $796 billion, so it looks like about 10 percent.

Senator **Kasten**. Yes, a little over 10 percent, and in the last year of the previous administration, 3 years ago, the rate of growth was about 18 percent.

So it is fair to say that we have cut it by a little more than a third. But still, the Government is not growing at the same rate as the gross national product. It seems to me that this is the short description of our problem. We have a Government rate of growth that is significantly greater than the rate of growth of our economy. Do you agree?

Dr. **Feldstein**. I think we have turned that around. That is, between 1983 and 1984, outlays as a share of GNP will come down, so GNP will grow faster than outlays. But if nothing is done to reduce spending in 1985, it will rise again as a share of GNP, and your statement would be right.

Senator **Kasten**. But the key is exactly what you have said—if nothing is done to reduce the rate of growth of Government spending, we are either going to pay for it with taxes or borrowing. The rate of growth of Government spending, primarily in defense and entitlements, is growing significantly faster and continues to grow. Whether we financed deficits with taxes or not, we cannot continue to have spending growing significantly faster than GNP.

Dr. **Feldstein**. You obviously cannot go on doing that for very long without it taking a larger and larger share of GNP.

Senator **Kasten**. That was the problem particularly during the late 1970's and the early 1980's. We have reversed that in part, but we have got to go further.

Dr. **Feldstein**. Total outlays as a percentage of GNP were about 18 percent in 1960; they got up to over 20 percent in 1970, and were over 22 percent in 1980. This current fiscal year, outlays will be 24 percent of GNP, and on a current services basis, without any further progress, they will get down to 23 percent by the end of the decade. But obviously, more can be done.

Senator **Kasten**. And during that period of time, revenue, as a percentage of gross national product, has been roughly the same–19 to 19.5 percent?

Dr. **Feldstein**. That is about right, yes.

SPENDING SIDE OF BUDGET NEEDS TO BE CONTROLLED

Senator **Kasten**. So, it is the spending side of the budget that we ought to be looking at, whether or not we do anything with taxes. Do you agree with that, that we have got to concentrate on the spending side?

Dr. **Feldstein**. Well, we have a difficult problem. We have a very large deficit. We have been successful in reducing spending a bit, but what we have proposed in this budget are further ways of bringing down domestic spending, and reducing the defense request relative to last year's request, and that will make some difference.

Chairman **Domenici**. Would the Senator yield for a question?

Senator **Kasten**. Certainly.

Chairman **Domenici**. Let me just ask a clarifying question on taxes.

Do you know what portion of that 19.2 percent or 19.3 percent of GNP that revenues make up is now represented by taxes for trust accounts like social security?

Dr. **Feldstein**. Social security alone has gone up from about 2 percent of GNP in 1960, almost 6 percent of GNP now. So it has just about tripled as a percentage of GNP. The remaining taxes, which include some of the trust taxes but are mainly the personal and corporate income taxes, have come down from 16.4 percent of GNP in 1960 to a little less than 13 percent of GNP this year.

Chairman **Domenici**. Thank you.

SPENDING CUTS HAVE NOT COME

Senator **Kasten**. Thank you, Mr. Chairman.

In 1982 we passed a tax increase bill—TEFRA—that same year we adopted a budget resolution that would have increased taxes by roughly $100 billion, and cut Government spending by roughly $300 billion over 3 years. That was the sense of the budget resolution that was adopted.

Now, in this budget, you are recommending tax increases of $33.7 billion over the next 3 years. Don't you think that we ought to be talking about getting the spending reductions firm and in place first, and then going back and talking about the necessity of reducing the remaining gaps through tax increases?

It seems to me that we bought off on a tax increase package. The taxes went into effect the day we passed the bill, and instead of getting the ratio of $3 in spending reductions for $1 in revenue increases over that period of time, we have actually increased spending by $1.17 for every dollar of increased revenue.

Can't we concentrate on the spending side first?

Dr. **Feldstein**. I was not here in 1982, so I do not really know the history of what happened then. But I think one of the advantages of the negotiations is that if we can put together a package with all of the elements spelled out at once, then there will not be any questions about just how much should be done, and in what way. I think that may be a way of giving everyone confidence that they know exactly what the components of the package would be.

Senator **Kasten**. The fact is that the Congress owes the administration $3 in spending cuts before we even begin the negotiations.

The administration made a commitment to this deal, and we, in fact, accomplished part of it. And then, what has happened is that——

Chairman **Domenici**. What negotiations are you talking about?

Senator **Kasten**. The negotiations over the budget in 1982.

83 PERCENT OF CONTEMPLATED BUDGET SAVINGS ENACTED

Chairman **Domenici**. Well, I have got numbers different from yours; 83 percent of the budget savings contemplated that were congressional were enacted, 83 percent.

Senator KASTEN. But then we had the add-ons coming from other kinds of programs that were not, I guess, part of those original negotiations.

Chairman DOMENICI. Well, it is impossible, unless you want to change the Congress, to do that. What I am saying is that it is an absolute myth to run around and say that Congress did not do what it said it would do. It did 83 percent of what it said it would do.

Senator KASTEN. But we have increased spending, not decreased spending, from the time that we put the tax increase in place. What I have tried to suggest to Dr. Feldstein is that we concentrate on making sure that, before we start putting more taxes in place, we start to reduce the rate of growth of Government spending.

Chairman DOMENICI. Well, I would say to my good friend, in all deference and respect, that you would then be saying that before we ever change the tax structure so as to increase taxes, we are going to have maybe a—what would you settle for—a 10-year commitment on what the budget will look like for each and every year thereafter? How do we do that?

Senator KASTEN. Well, if we could get a handle this year, on defense and entitlement programs, then and only then, could we even increasing revenues.

Chairman DOMENICI. Well, I do not want to use your time, and this does not count.

Senator KASTEN. My time expired anyway, Mr. Chairman.

Chairman DOMENICI. At any rate, I am merely suggesting that the items you have just recommended, domestic spending and military, are appropriated accounts. And if we made a deal that we will cut those $50 billion in exchange for $25 billion in taxes, I do not know what there is to assure the people of this country that 2 years hence, Congress will not add some money to defense. So, under your logic, we would not change the taxes, because there is no way to do that—how can we do that?

Senator KASTEN. I would work for making the spending changes and putting those spending changes in place now.

My time is expired. Thank you, Mr. Chairman.

Chairman DOMENICI. Senator Exon.

ECONOMIC DOWNTURN PREDICTION

Senator EXON. Thank you, Mr. Chairman.

Dr. Feldstein, I will renew my question that I asked in my opening statement that you did not get a chance to respond to. As an economist, in what year would you expect the next significant downturn in the economy if the budget before us is accepted and passed by the Congress?

Dr. FELDSTEIN. Senator, there is certainly no indication now of an economic downturn, and there is no way to predict when an economic downturn will occur.

I would hope that Congress is going to do more than just what is in the budget. I hope that these negotiations are going to succeed. I hope that the public will understand that they are just a first step. And I think if that happens, we can have a very long expansion, unless there is some unforeseen outside shock to the economy.

Senator Exon. Would you say that if we accepted the budget before us as recommended by the President and did not do anything else, that there would be a high likelihood that we would see a downturn in the economy in the next 3 years?

Dr. Feldstein. No, I would not want to say that, either. I am saying this as a professional economist—I think it is very difficult ever to forecast an economic downturn spontaneously occurring sometime in the future.

If you look at the Congressional Budget Office figures, for example, although they make their forecasts without assuming a significant decline in budget deficits, they do not assume an actual economic downturn. They assume a somewhat slower rate of growth than we have, and I think that is basically true of most of the leading private forecasters.

DECREASE IN INTEREST RATES PROJECTED

Senator Exon. But you did project in the future a significant decrease in the interest rates. Why is it that we can magically produce figures that show the interest rate is going to come down—which I assume is one of the reasons that we have a pretty rose-colored glasses approach to the figures that we have been presented.

Dr. Feldstein. Interest rates are very important to the deficit calculation. But there are two predictable things that drive the interest rates: inflation and the Government's borrowing. If the Government's borrowing is down, as we assume, and if the monetary policy is sound, as we assume, then interest rates ought to come back in line with the kind of experience that this country had in the fifties and sixties.

So I think that is the kind of long-term prediction that economists can be comfortable with. But actually picking a date and saying that in this year or that year, there is going to be an economic downturn spontaneously, or as a result of an accumulation of unidentified forces, is something that we cannot do. When you get very close to a downturn, then there are signs, and you begin to see in the leading indicators some indication of a downturn. But right now, the leading indicators are up, and have been up 15 out of the last 16 months.

Senator Exon. Well, Dr. Feldstein, if I look, as a noneconomist, at the budget that was sent over to us by the administration, and I see the rosey growth in the economy predicted therein, and the significant downturn in the interest rates, I might be tempted to say, why don't we just accept it, what's wrong with it——

Dr. Feldstein. Let me emphasize, Senator, that we are very, very clear that economic growth, and a downturn in interest rates, will only occur if there is more progress than $180 billion deficits, like the results that we are hoping for in the negotiations, followed up in 1985 by additional legislation. If we get that, then I think that that kind of economic performance is perfectly reasonable to forecast. If we do not, then I do not think we can get that kind of economic success.

PRESIDENT CONSIDERED OPTIONS TO AVOID STALEMATE

Senator **Exon**. When did the President decide that his budget was seriously flawed, and that he was going to have to come up with this idea of doing more? Was that the date of his state of the Union Address, the day before that, or when?

Dr. **Feldstein**. I would not describe it as "deciding that the budqet was flawed." I would say that the President had considered a number of options to try to avoid the kind of stalemate that we had last year, when the President sent over a budget and saw no action from the Congress; rather than have a repeat of that, the President was looking at alternative ways of dealing with the problem. No doubt you heard about the possibility of a commission that would take a long time and examine more substantial changes. But I think the President concluded that he really wanted to see something done quickly, and that bringing together a bipartisan group, as has been done on other issues, was the best way to get something done right away.

Senator **Exon**. So what you are telling me is that the President came up with this idea sometime before the budget numbers were put together, and that from the early decisionmaking process, the idea of a bipartisan commission to really solve the problem was part and parcel of putting together the numbers, rather than the commission being an after-the-fact decision?

Dr. **Feldstein**. I do not think I should really talk about the internal, detailed deliberations. I will say again that the President wanted to get action this year and felt that last year, our experience had not been satisfactory.

KEY REASONS FOR ECONOMIC UPTURN

Senator **Exon**. Dr. Feldstein, give me your professional opinion on what you think are the key reasons that we are presently seeing the economic upturn. I have a suspicion that maybe there were three prime factors. In the first place, is it not true that usually, when we inject into the economy a great deal of money from Government spending and record deficits, hasn't economic history generally told us that that spurs the economy in at least the short term?

Dr. **Feldstein**. Do you want to tell me the other two, and then I will try to answer it all at once, or do you want me to respond to one at a time.

Senator **Exon**. I would rather you do it one at a time. I do not mean to trap you——

Dr. **Feldstein**. OK.

Senator **Exon**. Let me give you the other two.

Dr. **Feldstein**. All right.

Chairman **Domenici**. Senator, Your time has expired, but we are going to let you do this if you hurry.

Senator **Exon**. Isn't it also true that during a wartime economy, we generally have good times? Don't the good times roll? And third, when we have massive tax cuts, do not generally, historically, economically, the good times roll?

It almost reminds me of the fact that maybe you Republicans will be singing, "Happy Days Are Here Again."

Chairman **Domenici**. We are already singing it.

Senator **Exon**. Are you?

Chairman **Domenici**. Yes.

Senator **Exon**. Well, then, stay on tune.

TAX CUTS AND GOOD MONETARY POLICY

Dr. **Feldstein**. I would say that a combination of the tax cut and good monetary policy have contributed to this recovery. I think the deficits have been a double-edged sword. On one side, we have the favorable effect of immediate stimulus to demand, but I think the projection of deficits out into the future has kept real interest rates high, and that has dampened the interest-sensitive sectors of the economy and hurt our trade.

So I would not point to the deficit as a prime mover in this recovery. But I would talk about the tax cuts, and I would talk about good monetary policy that, once inflation was brought down, was capable of supporting a strong expansion.

WARTIME ECONOMY

Senator **Exon**. What about the wartime economy?

Dr. **Feldstein**. I do not see this as a wartime economy. We have a much smaller share of our GNP being spent on defense now than we did in most of the peacetime postwar years, let alone during war. With 6.7 percent of GNP being spent on defense, we are way below the almost 10 percent share in 1960.

Senator **Exon**. So, you do not think we should cut back on—I yield.

DEFENSE SPENDING

Chairman **Domenici**. I just want to say this. Two trillion dollars is what you are planning to spend on defense for the next 5 years—$2 trillion.

Dr. **Feldstein**. Even though I like numbers, I find these numbers so big that I think they are misleading. What we are planning to spend on a current services basis, Senator, is 7.3 to 7.8 percent of GNP. By comparison, in 1960, it was 9.7 percent of GNP. So it has actually come down.

These large numbers, added up over 5 years do sound very, very big, but over those 5 years, we will have approximately 20-plus trillion dollars' worth of GNP.

Senator **Riegle**. Well, $2 trillion in 5 years is a lot of money for defense.

Chairman **Domenici**. Senator, we are going to give you another turn.

Senator Quayle?

REDUCE SPENDING GAP

Senator **Quayle**. Thank you, Mr. Chairman.

Dr. Feldstein, in your professional opinion, how should a gap of about 4 percent of GNP in the deficit be narrowed?

I mean, we have got basically three choices—cut spending, raise taxes, or to see the economy grow. I do not believe anybody has suggested that economic growth alone will narrow the deficit to where it should be narrowed.

So how do we prioritize this? Which direction should we go? I think all of us appreciate your candor and the way that you have been very direct. Now, strictly from an economic and not a political point of view, we will be collecting 19.5 percent of GNP in revenues, and spending 23 percent of GNP that may go back up to 24 percent—where should we be narrowing this gap?

Dr. **Feldstein**. As a strictly technical economic question, I do not think I can really answer that.

BALANCING OF PRIORITIES

Senator **Quayle**. Well, how about a general economic response? We really need some direction in this. This is an ongoing debate. I think it is exceedingly important as we try to prioritize and see where we should be going from an economic point of view—then we can make the decision whether politically we can do it or not.

Dr. **Feldstein**. I think the division between public and private priorities, and the division of Government spending between different programs, goes beyond a technical economic question or even a broad economic question. So I think ultimately that it is a question that you have to answer, rather than one that I, as an economist, have to answer. But I think there are some guidelines.

I think that what we know is that some ways of reducing that deficit are going to have more adverse effects on the economy than others. If we raise marginal tax rates, we reduce incentives. If we cut back spending for research and development, we hurt our growth.

So there are certain things that I think in principle, we ought to be steering clear of. In the end, it is going to have to be a balancing of policies.

Senator **Quayle**. When you say a balance, are you looking roughly in terms of 50/50?

Dr. **Feldstein**. No, I am not suggesting anything like that. I think that in the near term, the negotiators within this bipartisan negotiation have to have a clean slate, and after that, it is really not for me in my current position to make any recommendations.

RELATIONSHIP OF SPENDING TO GNP

Senator **Quayle**. OK. Let me get beyond the political waters of this bipartisan commission. I hope it is successful, and I hope the downpayment is successful. I think it could lay the foundation for more substantive reforms later on. But I do not want to deal with that question right now. What I am trying to do is to look in broad general terms and parameters.

What percentage of the gross national product from a Federal point of view should we be spending if we are to be a nation with rates of productivity growth as high as they should be?

Dr. **Feldstein**. There is no economic answer to that.

Senator **Quayle**. There is no answer?

Dr. **Feldstein**. There is no answer to that question.

Senator **Quayle**. Well, about?

Dr. **Feldstein**. No, I really cannot give you an answer on that.

Senator **Quayle**. You cannot?

Dr. **Feldstein**. No, I cannot give you an answer. I cannot distinguish that without talking about how taxes would be raised to pay for that and what the spending would be on.

I am sorry. I do not mean to be evasive, but that is, unfortunately, Senator, where I am.

Senator **Quayle**. Well, I guess maybe you are more sensitive to giving that information out. Don Regan says that spending, ought to be around 21 percent, and Stockman said, I think, around 23 percent. And you want to pass.

Dr. **Feldstein**. Yes, pass.

Senator **Quayle**. That is not your character.

Dr. **Feldstein**. That is not an economic question.

Chairman **Domenici**. Yes, but maybe he knows what he is talking about. [Laughter.]

Senator **Quayle**. Well, if he knows what he is talking about, he ought to tell us.

Chairman **Domenici**. And he is. He is telling you there is no magic. These other fellows saying anything over 19 percent, we are going to have a depression, and so on. They do not know that.

Dr. **Feldstein**. There is no right number. It depends on what you spend it on and what you cut back.

Senator **Quayle**. OK, but I think, in all due deference to my chairman, that it would be helpful if we could develop some sort of a consensus on where we ought to be in relationship of spending to GNP, or revenues—either one. If we would establish that it would be 20 or 21 percent, or 22 percent, then we could set targets.

REDUCE EXPENDITURES OR RAISE TAXES

Chairman **Domenici**. Let me try a question, and see if he can answer—could I?

Senator **Quayle**. I have a couple of other questions, and then you can.

Chairman **Domenici**. This is on yours, just on your point, to see if I can get him to answer.

Senator **Quayle**. OK, but shut the clock off.

Chairman **Domenici**. Forget any kind of social policies of the country. You are not being asked to pass judgment on who ought to get helped or who ought not get helped. I think the Senator is trying to get some kind of feel from you as to whether anybody would be better off over the next 10 years if we were to reduce that deficit by reducing expenditures or raising taxes, or is it not possible from your education and your experience to give us some advice in that regard?

Dr. **Feldstein**. As I listen to you ask the question, it sounds like I could reduce defense spending without having any adverse effects——

Chairman **Domenici**. Yes, sir.

Dr. **Feldstein** [continuing]. And I could reduce social spending without hurting anybody——

Chairman **Domenici**. Yes, sir.

Dr. **Feldstein**. Well, that is too easy. I will do that.

Chairman **Domenici**. That is what you were asking, wasn't it, Senator?

Senator **Quayle**. I am trying to get a feel, really, for what kind of direction we ought to be going in. I mean, this debate has been kicked back and forth on spending or taxes, and then we have had the two previous witnesses, who gave us at least some benchmarks.

Dr. **Feldstein**. Quit while you are ahead. You have two answers.

BROAD BASELINES OR POLICY TARGETS

Senator **Quayle**. I was trying to get some benchmark from Dr. Feldstein to see if, in fact, we could develop some sort of a consensus. It is much easier from a political point of view for us to have broad baselines or policy targets to shoot for. And if we are all over the lot, then the chances for consensus and to get something done in a constructive manner is dissipated. And that is why I was pushing on it.

Dr. **Feldstein**. I wish I could be more helpful.

Senator **Quayle**. And I see that you want to take the balanced approach, which is not terribly helpful, because I think we really need to do this—notwithstanding the defense aspect. It would certainly be helpful to at least this Senator, if we knew what we should be shooting for as far as revenues as a percent a GNP—and I have heard ranges all the way from 20 to 24 percent. And that is a big gap.

Dr. **Feldstein**. But there is no right answer, economically, without asking how that money is going to be spent; what our needs are for defense, what payoffs are associated with infrastructure programs, what payoffs are associated with research and development programs, what the political consensus is about meeting social needs.

So I really cannot give you a magic number. I think the other thing to bear in mind is that what we are seeing here is about two-thirds of total Government spending in this country, because of State and local spending.

UNDERTAXED OR OVERTAXED NATION

Senator **Quayle**. Let me ask one other question. Are we as a nation, on a comparative basis with other industrialized nations in this world, an undertaxed country?

Dr. **Feldstein**. I do not like to ever use the word "undertaxed." We are taxed less than most other industrial countries and we spend a much smaller share of our GNP through the public sector. But I think those other countries are often suffering because of the very large share of their national income that they put through the public sector and the way in which they finance it.

Senator **Quayle**. So in other words, our Government consumption of taxes, at 19.5 percent, what it is today, is lower than in other nations. But you are not willing to say that we are in fact, being undertaxed.

Dr. **Feldstein**. I find it hard to say that word, "undertaxed."

Senator **Quayle**. Well, let me try again. Do you think we are overtaxed as a nation?

Dr. **Feldstein.** I think we have a tax system which needs change. I think we have made improvements in it in the last few years, and I commend the Congress for doing that. There is more that needs to be done. I think we can reduce the burden of the tax system by changing it, and I hope that that will be one of the products of the Treasury's study this year.

Senator **Quayle.** That gets to tax simplification, on which I will have a couple of questions in round two.

Thank you, Mr. Chairman.

Chairman **Domenici.** Senator Metzenbaum.

RAISING TAX REVENUES

Senator **Metzenbaum.** Dr. Feldstein, it is pretty obvious that last year, the chairman of this committee and the ranking minority member, the chairman of the Finance Committee, the Chairman of the Ways and Means Committee, had all moved forward with respect to a budget, with respect to some revenues and some cuts.

The administration absolutely turned hands down, and they were frustrated. Now we see the President sending over 9 pages, in his Economic Report saying that it is all Congress fault, and we have to wait until 1985 and that in order to really do something, we ought to have a downpayment.

I think that we have a right to question the sincerity and the bona fideness of the administration, because I think it is purely a political ploy.

But because I am willing to examine the issue and take it at face value, I would like to ask you, how would you raise the tax revenues—do not tell me we are going to go into negotiations, and everything is negotiable. You are the chief economic adviser of this administration. Now, I know there are some things in the budget, and I have read part of your report about tax revenues, but I cannot find anything there to indicate. As you know, I have talked with you on the phone about closing tax loopholes. What would you do to raise the tax?

Give us some ideas that would be put on the table if you and I were negotiating, which we are not.

Dr. **Feldstein.** First of all, let me emphasize that I believe the President is sincere about this. I think you should take it at face value. I think that we have a very sincere desire to reduce these deficits, to get progress, and we recognize the political reality that there is no point in the President sending up the budget to a hostile Congress; it is much better to sit down and do serious negotiations.

Now, the administration——

Senator **Metzenbaum.** This Congress is not hostile, I might say.

Dr. **Feldstein.** Good.

Senator **Metzenbaum.** You keep saying a hostile Congress; that man has tried to negotiate, Senator Dole has tried to negotiate, Senator Baker has tried to negotiate, Mr. Rostenkowski has tried to negotiate. And you say something about sincere. I am saying to you that up until this point, he has given no evidence, and even since he has made his big speech, you said that everything is negotiable, but he says do not touch defense spending, and do not touch any tax increases.

Dr. **Feldstein**. Let me quote the President to you.

Senator **Metzenbaum**. Well, I would be glad to do that to you, also.

Chairman **Domenici**. Who is going to go first? [Laughter.]

Senator **Metzenbaum**. You go ahead. You put your quote on the table, and I will put mine on.

Dr. **Feldstein**. This is what is known as a bipartisan negotiation.

Chairman **Domenici**. You go first. You are the witness.

NEGOTIATING DOWNPAYMENT ON DEFICIT

Dr. **Feldstein**. The President said, about negotiating a downpayment on the deficit: "I am serious about negotiating a downpayment on the deficit. This is not a political posturing, as someone suggested. I am not ruling anything out as beyond the bounds of legitimate debate."

Senator **Metzenbaum**. He also said: "The deficits we face are not rooted in defense spending, nor is the deficit, as some would have it, rooted in tax cuts. The fact is, our deficits come from the uncontrolled growth of the budget for domestic spending." And he said that in his state of the Union message last year.

Dr. **Feldstein**. And if you look at the historic record, it is very clear where the growth of spending has come. If you look at it over the last two decades, domestic spending has doubled as a share of GNP, and defense has come down from 9.7 percent of GNP to 6.7 percent of GNP. So you cannot fault his description of how we got to spending 24 percent of GNP.

Senator **Metzenbaum**. Well, you also know that this morning the chairman pointed out to us that all of the spending that the President proposed, that the Congress came up with $30 billion less. So you cannot say that we did it——

Dr. **Feldstein**. I am not talking about what happened last week or last year. I am talking about what has happened over a quarter of a century. Over a quarter of a century, nondefense spending has doubled as a share of GNP, from 7.5 percent of GNP to more than——

Senator **Metzenbaum**. What does that have to do with today? Let's talk about today. What are you going to do about the tax revenues? How are you going to raise them? That is my first question, and my only question, because apparently, we ran out of time while you and I were making quotes.

TAX-EXEMPT LEASING

Dr. **Feldstein**. The Treasury has indicated a number of changes, some of which I am sure should appeal to you. For example, one of the most important loophole closings deals with tax-exempt leasing. This is a very important loophole closing. The Treasury estimates, by preventing that abuse, by preventing nonprofit organizations from, for example, selling a townhall to a group of investors and renting it back——

Senator **METZENBAUM**. I understand that, but you know, at the same time, the Assistant Secretary of Commerce is advocating tax shelters as a means of financing—he is advocating it.

PRIVATE-PURPOSE TAX-EXEMPT BONDS

Dr. **FELDSTEIN**. You asked me what the administration wanted to do, and I give that as an example, $6.5 billion over 3 years.

Private-purpose tax-exempt bonds. We have the Federal Government financing through the tax laws all kinds of private expenditures that should not be financed that way.

Senator **METZENBAUM**. You know, Dr. Feldstein, that both of those, I tried to do something about it in the last session, and the administration fought me tooth-and-nail—you are aware of that?

Dr. **FELDSTEIN**. Well, here it is. It is in the Treasury's list of things that they would like to do. There is a list of so-called technical accounting proposals that would represent more than $7 billion. These are——

Senator **METZENBAUM**. Well, they should have done that already.

Dr. **FELDSTEIN**. OK, but you asked what the administration wanted to do, and the administration is proposing $33 billion of loophole closings over 3 years.

REVENUES RAISED BY CLOSING TAX LOOPHOLES

Senator **METZENBAUM**. Let me ask you, how much do you really think they could raise if they actually moved in and closed some of the major tax loopholes—and I mean the egregious ones. I am not talking about mortgage interest deductions, which is not a loophole. I am talking about some of the egregious loopholes that exist. Could we pick up another $100 billion in that 3-year period?

Dr. **FELDSTEIN**. I do not have a number in mind, but I believe we could do at least this much, and I think the negotiating group ought to sit down and look at a whole list of tax loopholes as a way of helping to bring down this deficit without increasing the tax burden on individuals who are not taking advantage of them.

Senator **METZENBAUM**. My time has expired. I gather we will have another round.

Chairman **DOMENICI**. Yes. Thank you, Senator.

Senator Kassebaum?

DECLINING INTEREST RATES PROJECTED

Senator **KASSEBAUM**. Dr. Feldstein, I think I am probably joining a chorus here, and my apologies for coming in late, to tell you how much I value your very candid, very professional, and very valuable advice on our economic picture today.

Dr. **FELDSTEIN**. Thank you.

Senator **KASSEBAUM**. I think it is something that all of us on the Budget Committee have appreciated.

I, since I have not heard all the questions, would only like to ask one, that I understand has not been touched on, and that is the fact that the President's budget projects a series of declining interest rates, based on short-term T-bills, from 8.5 percent this year to 6.2 percent in 1987.

Certainly, as you are well aware, this is inconsistent with the private forecast, and it is really inconsistent with the deficits in the President's budget.

Does this inconsistency trouble you as we look to the future and planning?

Dr. **Feldstein**. We are very explicit about that inconsistency in the economic report. We make it very clear that we only think we can get that kind of decline in interest rates if we get significant reductions in the budget deficit.

I think that the private forecasters in the financial markets are not as sanguine about, or are not making that assumption about, future success in reducing budget deficits and pursuing an anti-inflationary monetary policy.

If we do not get that kind of fiscal and monetary policy, then I do not think we can get those improvements in interest rates. But if we do, then what we are basically talking about is taking the real interest rate back to the kind of level it has had historically, about 1.5 percent in excess of inflation.

DEFICITS MAJOR FACTOR IN KEEPING INTEREST RATES HIGH

Senator **Kassebaum**. Do you view the deficits as the major factor in keeping interest rates high?

Dr. **Feldstein**. I think they are. I think that the reduction in the outyear deficits would be a significant help in bringing these interest rates down and in permitting the Fed to pursue a policy that does not lead to additional inflation.

DEREGULATION OF INTEREST RATES

Senator **Kassebaum**. In visiting with some members of the financial community, they maintain that, really, because of pressures that we have built in through deregulation, and the emphasis on competition for higher interest rates, they really cannot go down very far; that there has been this really enormous pressure that is building among savers for the best place to put their money, whether it is in CD's or return on the money market funds, whatever might be available; and they are shopping around for the highest interest rate.

How does that really relate to the deficit?

Dr. **Feldstein**. I do not think that that has much to do with the deficit, or, frankly, with the high real interest rates. Of course, certain interest rates that used to be controlled—passbook bank rates, that have now been released—have come up. But I think free market rates, like the Treasury bill rate or the CD rate, find their natural level depending upon the supply and demand of savings. People were certainly very keen to get the highest return that they could on their money back in the late seventies and early eighties, when interest rates were very high and inflation was eating into the value of their deposits, but real interest rates were frequently negative in those periods of high inflation.

So, I think that deregulation really has not pushed up the level of market rates, and that as inflation expectations come down, and as the fear of these budget deficits competing for funds diminishes we will see much lower market rates of interest.

Senator **Kassebaum**. I do not have anything further. Thank you.

Chairman **Domenici**. I assume that the two Senators who remain want to go a second round.

Senator **Exon**. Yes, I do, Mr. Chairman.

Senator **Quayle**. Yes.

REASON FOR HIGH REAL INTEREST RATES

Chairman **Domenici**. I will just ask a couple questions now.

I was going to ask the same question. Let me see if I understand your answer correctly. Why are real interest rates so high—your answer was that the principal reason is because of the projections of high deficits, combined with those in the marketplace not seeing any evidence that they are coming down.

Dr. **Feldstein**. That is right.

Senator **Domenici**. Would you explain again why you think that has an impact on interest rates—fundamentally, simply, so we will have it on the record.

We have had very profound witnesses say it was not so. I hope you understand that.

Senator **Quayle**. I think expectations was the word we heard this morning.

Chairman **Domenici**. Well, I do not want to put all those qualifiers on the people.

Strike all that from the record. We have had witnesses say that. I do not know about all that other business.

Dr. **Feldstein**. Basically, what we are projecting into the future, if there is not legislative action, is borrowing by the Government of roughly 4 to 5 percent of GNP. Net savings in this country—savings coming from households, from businesses, pension funds, State and local governments, after providing for depreciation—are likely to be 7 or 8 percent of GNP. So we are talking about the Government absorbing half of the available savings.

In order to squeeze down the demand for investable funds on the part of businesses and homebuilders to that 4 percent, we have to have a high price on those funds, and that price is the real interest rate.

BANKS DOING SHORT-TERM INVESTING

Chairman **Domenici**. Now, in our respective States, if the other Senators are like this Senator, we go around, visiting banks as we visit a community, or we visit a customer of a bank, or perhaps in the smaller communities, one of our friends happens to be on the board of one of the banks. And if they are hearing what I am hearing, those banks have more money available than the demand for loans, and they are placing them in various kinds of deposits of their own, short term on the big markets, so they get some return.

How does that stack up? In other words, don't the interest rates come down, especially short-term rates?

Dr. **Feldstein**. Of course, they are not just leaving $10 bills in the cash drawer at the bank. They are investing it in Treasury bills, where they can get 9 percent, or in commercial paper, where they can get more, so that the return that they can get for very liquid, very safe funds, is very high. As a result they have to charge an even higher amount to commercial borrowers for business loans.

Chairman **Domenici**. But I have seen the difference between the rates they receive when they are investing in those commercial transactions and the rates they charge when lending to customers. I have seen another 3, 4 percent there, in addition to the already high real rates. Is that just the way the banks do business?

Dr. **Feldstein**. The current spread between the prime rate and the Treasury bill rate, or between the commercial paper rate and the Treasury bill rate, is not at all unusual. That kind of spread is what we have had ever since the prime ceased to mean what it used to mean.

INFLOW OF CAPITAL FROM ABROAD

Chairman **Domenici**. How important is the flow of money from outside America to our ability to maintain a capital supply at this point in history, from the point of view of all different borrowers?

Dr. **Feldstein**. That is a very important point. It is very important now. This year, 1984, we expect that the inflow of capital from abroad will be more than 2 percent of GNP, and total net investment in the economy will probably not be much more than 4 percent of GNP. So, foreign funds coming in will finance about half of all the net investment.

Chairman **Domenici**. Well, I gathered from listening to Chairman Volcker that he, too, thought that was very important to the equilibrium that we have now, and that if it went the other way, it would be very, very tough.

Dr. **Feldstein**. It is. Those interest rates would just go right up.

Senator **Quayle**. Would the chairman yield for a second?

Chairman **Domenici**. Of course.

Senator **Quayle**. You say that compared to the last 2 or 3 years, this is going up? You say it is one-half this year——

Dr. **Feldstein**. Yes.

Senator **Quayle**. What was it the last couple of years?

Dr. **Feldstein**. Last year, we had a capital inflow of about 1 percent of GNP. The trade deficit, Senator, has gone from about $28 billion to $36 billion, to $61 billion last year, to what most experts expect will be more than $100 billion this year. And the inflow of capital is equal to that trade deficit, less about $25 billion.

Chairman **Domenici**. Let me make one observation, and then I am going to yield to the other Senators. This is as much to continue the dialog that you and I have had with reference to this task force or panel or summit, which is bipartisan in nature. Let me first say I do not think you ought to be too concerned about saying that even if the panel did only slightly more than is asked for in the President's budget, if as a matter of fact, they agreed on a mechanism to accomplish it then and there, I do not think you ought to assume that is not very significant action.

Dr. **Feldstein**. I agree. I think the crucial thing is action.

Chairman **Domenici**. Frankly, I can see this Budget Committee locked up in passing a budget resolution—and the first one is advisory for the most part—that has far more fiscal effect than the President's $72 or $106 billion, whichever way you want to figure it, but nobody will act on it, absent a reconciliation bill that forces them, and we even had one of those for the first time, where they would not even do what was reconciled.

So it seems to me that the effect of this bipartisan group is to say in this year, when nobody wants to make those tough decisions, be it a big cut in defense increases, or $30 or $40 billion in taxes, whatever, over 3 years, and some other entitlement restraint, and we will give lipservice to it, but then we will not do it—I think the strength of the bipartisan group is that they also will be asked to find a mechanism for accomplishing deficit reduction. And we are hoping to leave that reconciliation bill around and use it, which would, in the Senate, get it done very quickly, and we would be on with it.

MARKETPLACE ASSURANCE

Now I want to ask you a question about that. How do we ever make a 5- or 6-year commitment that the marketplace would respect and believe in, in light of the way we budget, the way we appropriate, and the nature of this whole fiscal activity of the Government? Now, you know as much as I that if you appropriate at a certain level, that does not mean it is binding for anything but one year. You know that if you cut defense 1 year, it is 1 year at a time. You know that on the entitlements, to get any restraint, you have to change the substantive law; that would be real. If you change taxes, it is real and perpetual, presumably, unless you make it a 1-year or 2-year kind of thing.

Can you tell us what kind of assurance the marketplace would want concerning a 5-year program; how do you see it in your mind?

Dr. **FELDSTEIN**. I, of course, agree with you that there is no way in which you can have an ironclad guarantee. On the other hand, changes in entitlements do carry into the future. A delay of the COLA has a permanent effect. A closing of tax loopholes has a permanent effect. And beyond that, just the indication of the Congress that they want to do certain things and agree to do them this year, such as set a lower baseline for appropriated accounts, makes it more plausible that they will follow through along the lines that they have agreed to within this bipartisan negotiation.

Chairman **DOMENICI**. Senator Exon?

Senator **EXON**. Thank you, Mr. Chairman.

Dr. Feldstein, you remember what I said about you earlier, and I mean everything that I said, and any of the questions that I have, do not for a moment think I am questioning your integrity.

Let me ask you a question or two, though. At Harvard, do you teach economics in the traditional sense, or do you teach and lecture on political economics?

Dr. **FELDSTEIN**. I suppose it would be called economics in the conventional sense—I carry chalk in my hand.

FINANCIAL ADVICE BASED ON ADOPTING ADMINISTRATION'S BUDGET

Senator **EXON**. Well, I might just say, because I am so keenly disappointed with this budget, that if I were in private industry, and I hired one of your graduates, and he brought me this budget to run my business for the next year, that has been produced here by the administration, I believe I would turn to Princeton—or, some other nonfootball school—for some help.

I want to seriously, though, try and get down to where we are going to go. And I am not going to say you were not forthcoming, but I did not get very far with my last round of questioning, so let me try another, and if you cannot answer, you cannot; I can understand that.

But let us assume that we adopt the administration's budget before us without change, and given that, as a respected economist, I think you would agree that your profession is continually trying to look through an opaque window as to what is going to happen to the economy in the future. And, while you might profess not to be a financial adviser, would you be good enough to give us your advice if we adopt a budget without any addition, as to what you would recommend to someone who had some money to invest or save? Would you suggest that they buy bonds, or buy stocks, or buy real estate, or buy Treasury bills, or buy gold, or run for the hills?

Which option would you suggest at this time, if we adopted this budget?

Dr. FELDSTEIN. Let me first say something to defend the potential market for my graduates from Harvard. If the business that you described had a board of directors that was as divided as the U.S. Congress, I am not sure what kind of a budget you would want to have put before them.

I think that the problem is not that we cannot think of things that need to be done and that can be done; I think the problem is that we have to find a mechanism, as the chairman said, that will actually achieve those savings. And the President's view is that, while indicating a starting line in this budget, we need to go beyond it, and that is the purpose of the negotiations.

As far as giving advice on what would happen in the hypothetical case that this budget was passed, I do not really think I should give financial advice publicly, or indeed, privately, these days.

POLITICAL BUDGET FOR A POLITICAL YEAR

Senator EXON. Dr. Feldstein, I characterized this as a political budget for a political year, rather than a realistic blueprint for sound fiscal policy, that I think the budget process anticipates from the President of the United States.

Am I wrong in that assumption?

Dr. FELDSTEIN. I would call it a realistic budget for a political year. I would say that the constraints on the budget this year, if we are really going to get something done, are very strong, and that while the budget explains what funds are needed for all of the different agencies and programs, and where their tax revenue will come from, I think—and I think last year's experience reinforces this—that if we are really going to make progress, it is going to have to be by serious, private negotiations among a handful of people.

VIEW ON GRACE COMMISSION REPORT

Senator EXON. Dr. Feldstein, one last question. I have been reading several reports on the Grace Commission report to the President, that the President seemed enthusiastic about, and then last night, I had a chance to read for the first time the article by George Will in Newsweek. George Will is a big supporter of the administration, usually, but he was highly critical of the Grace report.

My first question is, were any of the savings recommended in the Grace report incorporated in this budget, and what is your view of the Grace report as to what we might do to initiate some of the savings contained therein?

Dr. FELDSTEIN. I should say first that I am not at all an expert on the contents of the Grace report. I know what was done. I know that a large group of experienced businessmen came in as volunteers and examined very carefully the management procedures in all of the agencies of the Government. And I do not know the George Will article. So I start from ignorance in answering this.

I believe that a number of the agencies have been given at least are preliminary recommendations of the Grace Commission, and that they have started making changes that are reflected in this budget. But I know that much more is still going on. Within the organization of Office of Management and Budget, and within the individual agencies we are still in the process of pouring through the volumes of detailed management efficiency recommendations of the Grace Commission.

Senator EXON. Do I take it, then—and we are looking for ways to save money, I think, as you know—would you describe your reaction to what you know of the Grace report as one that should be given serious consideration as workable by this committee?

Dr. FELDSTEIN. I cannot say anything about each of the specific recommendations, and I do not believe that the report is the kind of document that is addressed to this committee. Rather, it is addressed to managers within the agencies, and deals with issues like how to handle cash management better, how to handle their inventories better, how to handle procurement procedures better.

I think it was that kind of issue, rather than broad policy, that was the primary focus of the Grace Commission, and I think that, with the kind of talent that was brought to bear, it certainly should be able to make a significant contribution to tightening up management within the individual Government agencies.

Senator EXON. You probably have not said it as much as I have, which is not a great deal, but I think basically, we can say that the report has about 25 percent of the savings that could be made through management savings, and about 75 percent of it would require congressional action.

Dr. FELDSTEIN. I know that a number of the things would require legislative action, as well.

Senator EXON. Thank you, Dr. Feldstein.

Chairman DOMENICI. Senator Quayle.

TAX SIMPLIFICATION

Senator QUAYLE. Thank you, Mr. Chairman.

I want to try to get definitional terms on what we mean by "tax simplification." I am well aware that the Treasury Secretary, and others, and the President has said in his state of the Union that there is going to be a report coming back to the Congress in December 1984, so I am not going to get into specifics. I have discussed this with you privately, and have reviewed not only my legislation, but some others.

When we talk of tax simplification in the present terminology, are we not looking on the individual income side of lowering marginal tax rates and trying to eliminate many of the deductions and credits, but yet, you would have basically probably a revenue-neutral-type situation on the individual side—is that a fair statement, just on the individual side?

Dr. **Feldstein**. I think that may be much too narrow a definition, at least of the kinds of things that the Treasury will look at. At this point, they are really just getting started. There have not been any decisions of any kind. But in testimony, Treasury has indicated that they want to look at a very wide range of things, including the kinds of broader—based, lower-rate proposals that you have suggested, but also including consumed income taxes, value-added taxes, and others.

Senator **Quayle**. Well, that gets me into the next question. I believe that tax simplification would follow general guidelines that I outlined on the individual side, but then when you get to the corporate side, you have to consider a transaction or a consumption-oriented tax, to achieve tax simplification. Isn't that what we are talking about when we look at tax simplification for business?

Dr. **Feldstein**. That is certainly an option, but I really think I should not comment anymore on a study that is just getting underway, because I think it would lead to inappropriate speculation about what it is that the Treasury is currently thinking about.

Senator **Quayle**. But can tax simplification, both for the individual and business, whether a transaction- or consumption-type tax, an idea or a vehicle that can be used to expand the revenue base in 1985 and beyond, assuming that we would not act in a substantive way until then?

Dr. **Feldstein**. Again, I think it is an idea that can be considered, but I really do not want to give a more specific answer, for fear that it will be overinterpreted by those who are trying to guess what it is that the Treasury will be coming up with months and months from now.

Senator **Quayle**. But do you support the idea of tax simplification?

Dr. **Feldstein**. I do, indeed.

Senator **Quayle**. And what does that mean? I mean, what is your definition of tax simplification?

Dr. **Feldstein**. Again, I really do not think it would be appropriate for me to pursue something that the Treasury is just getting underway on.

Senator **Quayle**. All right. Let me switch gears. In response to someone's question, I think you said that you thought the Federal Reserve policy was proper.

Dr. **Feldstein**. That is right.

THE 5 TO 7 PERCENT RANGE FOR M_1 APPROPRIATE

Senator **Quayle**. What do you think that the proper monetary policy should be between now and May 1, as far as expansion or contraction of the money supply?

Dr. **Feldstein**. I think that if we are to get the kind of real growth and modest inflation that we are looking for, that we are probably talking about a growth of M_1 in the 5 to 7 percent range.

Senator **Quayle**. In other words, 5 to 7 percent between now and May 1 would be compatible——

Dr. **Feldstein**. I do not like to get it down to a 4-month period, but I think looking out over the year ahead, something in the 5- to 7-percent range for M_1 and corresponding rates for the other aggregates would be appropriate.

INTEREST RATES COULD RISE FOR VARIOUS REASONS

Senator **Quayle**. If interest rates would start to go back up this spring—which, I suppose anything is a possibility—what would happen? What are we really looking at if they start to go back up?

Dr. **Feldstein**. There are different reasons that interest rates might go up. One reason might be that people became more and more concerned about inflation, afraid that we will have more inflation in the future. Another reason might be that if we saw a sharp decline in the dollar, financial markets would anticipate that a couple of years from now, there would be much less capital inflow, and therefore that real interest rates had to increase.

So it could either be that the inflation premium in interest rates rises or that the underlying real rates are higher.

Senator **Quayle**. So in other words, if the value of the dollar—which, I guess, by recent-day reports, has dropped a little bit, but it is still very strong, and we have no trendlines or indications that that is going to be any precipitous type of drop——

Dr. **Feldstein**. Correct.

Senator **Quayle** [continuing]. But you are saying that if, in fact, that would happen in the next 30 or 45 days, then there could be a counterproductive effect on the interest rates and the upward pressure that we——

Dr. **Feldstein**. You are basically right, but let me be clear about two things. One, I am certainly not predicting that that is going to happen.

Senator **Quayle**. I understand that.

Dr. **Feldstein**. The other thing is that if the dollar comes down, it depends upon the context in which it comes down. If it comes down because there is an anticipation that budget deficits will be smaller in the future, then we will not see interest rates rise, because the Government will be putting less demands on those markets.

Senator **Quayle**. That is sort of unlikely, though, in the next——

Dr. **Feldstein**. I think if we get a resolution out of these negotiations, and if it is seen by all the parties as just a downpayment, so that there is some sense that there will be a followthrough without opposition in 1985, then that in itself would tend to bring down long-term real rates. That might bring down the dollar with it, which would be a healthy and a helpful thing. But if instead, there was just financial uncertainty and concern about the future of the dollar that led to a spontaneous decline in the dollar, then financial markets would recognize that not only would the Government be borrowing a lot in the future, but there would not be the inflow of capital from abroad, and so interest rates would have to be even higher to clear the market.

KEY FACTORS FOR POSSIBLE INTEREST RATE INCREASES

Senator **QUAYLE**. Let me just ask, in your professional opinion, what would be the key factor or factors that we ought to be observing in the next few months to detect any possibility that the interest rates may be increased? The value of the dollar is obviously one of them, but what other factors—money supply?

Dr. **FELDSTEIN**. You can look at the money supply, but long-term interest rates, in some sense, are their own best predictor. There is no way that you can predict, unless you are a lot smarter than the market, where long-term interest rates are going to go.

If you can say that there is going to be a change in policy and that there is going to be a change in these deficits so if the markets will have confidence that the deficits are going to come down, then I think we will see progress on those interest rates.

Senator **QUAYLE**. But if we don't, then you will see regression?

Dr. **FELDSTEIN**. Not necessarily, but I think they will at least stay high.

Senator **QUAYLE**. Thank you, Mr. Chairman.

Chairman **DOMENICI**. Let me just ask a couple more questions, and then we are going to recess. Thank you very much for being here.

In terms of the interest rates, you know, it is amazing—if we do things long enough around this country, there gets to be even vested interest in things that are not good. I think I received more letters last month from constituents who were worried about interest rates on their deposits coming down than I did from constituents worried about the fact that they were too high.

As a matter of fact, I had to go to a meeting with a group of senior citizens to talk about the fact that it was good for the country that their passbook was yielding less interest than it was 6 or 8 months ago.

Now, there is no question, is there, in your mind, that the policy of this country ought to be such that we get interest rates down from this unrealistic disparity between inflation and the cost of money?

Dr. **FELDSTEIN**. I think it would be good to get those interest rates down, yes.

Chairman **DOMENICI**. And in your opinion, the best way to do it is to begin a process which I assume even you think is going to take a number of years to reduce the predictable deficits.

Dr. **FELDSTEIN**. That is right.

Chairman **DOMENICI**. Based upon what you know—well, the economy is doing well now.

Dr. **FELDSTEIN**. It certainly is.

DOWNPAYMENT WILL GIVE TIME TO MOVE AHEAD WITH PLAN

Chairman DOMENICI. This morning, we got another big positive signal. I was not kidding a while ago, when I said we are very pleased with it. As a matter of fact, I do think—and not necessarily my friend from Nebraska—but I think on the other side of the aisle, there is a sense of frustration and even some long faces because, as a matter of fact, the economy is doing well. We have the deficit lingering.

In your opinion, will the downpayment that you are talking about give us time to move ahead with a multiyear plan for major reduction, and will the economy continue to be buoyant if we do that?

Dr. FELDSTEIN. I think it will. I think that if we get the downpayment and it is seen as a downpayment, with the expectation of more action in 1985, and there is then a followthrough, we really will be doing the job.

Chairman DOMENICI. So, if we do that first step, is it your opinion that we have at least a number of—what, months— 18 months, or what?

Dr. FELDSTEIN. I think if you do it in the next few months, and then say that it is a downpayment, and you are going to come back in 1985, then the world is going to watch very carefully to see what happens in 1985.

Chairman DOMENICI. So it will carry us that far, and then we will have to take another significant action, multiyear in nature, to reduce it?

Dr. FELDSTEIN. That is right.

Chairman DOMENICI. I wonder if you could prepare for the record a summary of all of those trust account-type accounts and the taxes levied for them; give us your estimate of their state of solvency now and over a few years. When you have done that, draw a line and take the rest of the budget as presented by the President, or ours—whichever you want, or both—and tell us how much of a disparity there is between the taxes that we now impose on our people and our companies, and paying that part of the budget's burden.

Dr. FELDSTEIN. I would be happy to do that.

Chairman DOMENICI. When could we have that—1 week, 10 days?

Dr. FELDSTEIN. I would think we could do it within ten days, yes.

Chairman DOMENICI. My strong inclination is we are going to find that the disparity is large, but almost exclusively in taxes paying for general government, not trust account government. But I do not know that, and that is what I am asking you for.

Dr. FELDSTEIN. Just to say roughly, in 1984, putting aside the social security and medicare trust funds—as you say, there are others—outlays are about 17.2 percent of GNP, and receipts are about 12.8 percent of GNP. So that accounts for 4.4 percent of the 5.3 percent deficit that we have this year. I will get you the precise material. But I think that the general proposition that you are making is certainly right.

Chairman DOMENICI. And the reason that I raise the problem is that there is kind of a statement going around that was very applicable 4 years ago, that if you reduce the entitlements, change the

COLA's, freeze the COLA's on those entitlement accounts, then you are going to really have an impact on the budget. And I think the answer is going to be yes, you are. But the question that has to be asked is will the trust account recipients let you do that—not because they are necessarily against the restraint, but as a matter of fact, you will be using their taxes to pay for other parts of government. I think that is the way it is going to turn out when you produce that, and that presents a much different picture for these people than they have been thinking about.

We stand in recess.

[Whereupon, at 3:40 p.m., the committee was adjourned.]

[The following was subsequently supplied for the record:]

THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS,
Washington, D.C., February 29, 1984.

Hon. PETE DOMENICI,
U.S. Senate,
Washington, D.C.

DEAR SENATOR DOMENICI: Please excuse the delay in responding to your question regarding the trust fund deficits. We have compared trust fund outlays with trust fund receipts, excluding transfers from general revenue. We have included two categories of income: "Trust Fund" and "Total." Trust Fund income represents total fund income less transfers to the fund from general revenue. Trust Fund Surplus is thus Trust Fund Income less Outlays, while Total Surplus is equal to Trust Fund Surplus plus transfers to the fund from general revenue.

As you suspected, very little of the deficit for Fiscal Year 1985 is attributable to trust funds. Looking at the major social insurance trust funds (OASDHI, Federal Government Employee's insurance and unemployment insurance), we see that the current services trust fund deficit comes to $18.4 billion out of a total budget deficit of 207.6 billion. Supplementary Medical Insurance receives $17 billion from general revenue, without which it would run a $17 billion deficit. Thus most of the $18.4 billion deficit mentioned above is attributable to SMI.

If you have any questions, please let me know or have your staff contact Andrew Berg at the CEA (395-5100).

Sincerely,

MARTIN FELDSTEIN.

Major trust funds—fiscal year 1985 current services (billions of current dollars)

Old age survivors insurance (OAS):	
Outlay	163.2
Income	160.9
Surplus	−2.3
Disability insurance (DI):	
Outlay	18.5
Income	17.5
Surplus	−1.0
Health insurance (HI):	
Outlay	45.1
Income	45.4
Surplus	0.3
Supplementary health insurance (SMI):	
Outlay	21.3
Income:	
Trust fund	4.3
Total fund	21.1
Surplus:	
Trust fund	−17.0
Total	−0.2
Subtotal:	
Outlay	248.1
Income:	
Trust fund	228.1
Total fund	244.9

Surplus:	
Trust fund	−20.0
Total	−3.2
Civil service retirement and disability:	
Outlay	21.8
Income:	
Trust fund	20.8
Total fund	36.2
Surplus:	
Trust fund	−1.0
Total	14.4
Employee's health benefit fund:	
Outlay	6.9
Income	6.9
Surplus	0.0
Railroad industry pension fund:	
Outlay	6.3
Income	8.8
Surplus	2.5
Unemployment insurance:	
Outlay	24.8
Income:	
Trust fund	24.9
Total fund	28.1
Surplus:	
Trust fund	0.1
Total	3.3
Subtotal:	
Outlay	59.8
Income:	
Trust fund	61.4
Total fund	80.0
Surplus:	
Trust fund	1.6
Total	20.2
Foreign military sales:	
Outlay	12.5
Income	13.1
Surplus	0.6
[State and] local government fiscal assistance:	
Outlay	4.6
Income:	
Trust fund	0.0
Total fund	4.6
Surplus:	
Trust fund	−4.6
Total	0.0
Highway:	
Outlay	11.3
Income	12.7
Surplus	1.4
FAA airport and airway:	
Outlay	1.7
Income	3.1
Surplus	1.4
Subtotal	
Outlay	30.1
Income:	
Trust fund	28.9
Total fund	33.5

Surplus:	
Trust fund	−1.2
Total	−3.4
Totals:	
Outlay	338.0
Income:	
Trust fund	318.4
Total fund	358.4
Surplus:	
Trust fund	−19.6
Total	20.4

This is only a partial listing; all major funds (over $1 billion of outlays) are included.

The distinction between trust fund receipts and transfers from federal funds (general revenue) is somewhat arbitrary. There are loans from general revenue as well as payments for services from general revenue to the trusts the terms of which vary considerably.

VIEWS OF OUTSIDE ECONOMISTS

TUESDAY, FEBRUARY 7, 1984

U.S. Senate,
Committee on the Budget,
Washington, D.C.

The committee met, pursuant to notice, at 1:35 p.m., in room SD-608, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Kasten, Gorton, Chiles, Biden, Johnston, Metzenbaum, and Exon.

Staff present: Stephen Bell, staff director; and Gail Fosler, chief economist.

For the minority: Richard N. Brandon, staff director; and Garry Schinasi, senior economist for macroeconomics and fiscal policy.

Chairman Domenici. We are going to start now. From time to time during the day, we are going to have some additional Senators arrive. On the Democrats side Senator Chiles will be here shortly. They are apparently in some kind of a caucus. I told him I would start. Most Senators have to be finished around 3 or thereabouts.

OPENING STATEMENT OF CHAIRMAN DOMENICI

It is a pleasure to welcome you to this committee. Dr. Jack Carlson is chief economist of the National Association of Realtors; Peter Herder is president of the National Association of Home Builders. It is a pleasure to have you with us. John Motley is director of legislation of the National Federation of Independent Business, and Mr. Alexander Trowbridge is president of the National Association of Manufacturers.

This is not new to most of you. You have discussed your organizations' views on the budget with this committee before and with me personally many times in the past. Indeed the future of American business and especially the housing industry depends on our success in bringing the large deficits down. At least that is how I feel and the compelling majority here feels.

OPPORTUNITY FOR DOWNPAYMENT ON DEFICIT

I say to you, however, what I said to others during the past couple of weeks. We have an opportunity to get something done. We have been asked to get together and begin an effort, a downpayment on this deficit. We have a vehicle in that there is a reconciliation bill pending on the calendar which could be used.

I am optimistic that with some patience and some commonsense and some commonsense members from both parties, both Houses, we can put such a package together and pass it.

There are some who appear to be discouraged. They say that what is being offered is inadequate. We ought to do more.

I wish we could. I hope we can, but I clearly think we have got to start somewhere, knowing the history of how we do things.

The President's budget is clearly one that can be accomplished. Again, I hope we can do more before we are finished. I am convinced, however, that no faction, no solution has a majority support of this Congress at this point.

So the sooner we get on with something that has a chance of bringing enough people together to get through a substantial deficit reduction the better off we are.

Now we have a President who says, Let's wait to undertake fundamental reform until after the American people have spoken in November. Let's wait until the people of this country have indicated whether to validate the course we have begun—to hold spending and taxes down as much as possible, or to change course. But, now let's do what we can and make a downpayment of at least $100 billion. It is as simple as that.

I for one have no doubt that the President supports the particular proposals in his own budget. Frankly, I am amused to see all of the controversy about that. But, he is clearly willing to listen to the Congress proposals with an open mind—and will actively support legislation if we can reach an agreement. I am optimistic that we can accomplish a great deal through this process of negotiation.

You, gentlemen, and organizations you represent are involved in the legislative process. You understand the difference between rhetoric and reality. It is for this reason I am particularly interested in your views on the President's budget, the effect of the downpayment approach to budget action this year, and on the longer run course we should pursue.

Senator Johnston, would you like a few opening remarks?

OPENING STATEMENT OF SENATOR JOHNSTON

Senator **Johnston**. Just a couple of remarks.

Mr. Chairman, this is a distinguished group. This group is in the forefront of those who have been trying to do something about this terrible hemorrhage that we have in the budget deficit.

The doomsday scenario that I fear is that by the time the Congess and the President get around to being in the political mood to do something about it, that is, 1985, that we will be in the early stages of a recession and that the economists will then tell us, "You cannot cut the budget in a recession."

We have heard that song before, and you can cut it this year. I know the political difficulties. I know it is very difficult to do so, but I think we really need to try to do this, and I do not have any naivete about how difficult it is to do.

PRESIDENT'S BUDGET RIDICULOUS

We have tried to do it the last couple of years, but in my view, this downpayment approach is silly. I mean, to present the kind of budget that the President has presented this year I think is, well, let me use a mild epithet, ridiculous. Really it is ridiculous to run this country into these kind of deficits and to do intentionally and to do it while all the time saying that you are still loyal to the balanced budget is, I think, ridiculous.

The downpayment idea, I guess that is some approach. I would like to see us do something in a grander way because the problem with a downpayment is you have to pick out one of the areas to be cut or to save revenue, whether it is taxes or whatever, and the way I feel is that I do not want to cut just one part. I do not want to deal with just entitlements. If you just put up entitlements, I would probably vote no because I think there ought to be a corresponding cut in defense or corresponding increase in taxes.

So I would just urge this group, leaders as they are in helping to cut that budget, to let us see if we cannot get a movement started. Mr. Chairman, I think you are probably in the mood to do that, and I will certainly join with you and with others who are of a like mind.

Chairman **Domenici**. We are going to proceed now. As I indicated, we are going to try to finish around 3 or 3:30.

Dr. Carlson, you proceed first. Do you have prepared remarks?

Dr. **Carlson**. Yes, sir.

Chairman **Domenici**. How long would they take?

Dr. **Carlson**. I will stay within the 10 to 15 minutes, if you can allow that amount of time.

Chairman **Domenici**. All right. We are going to make your statement a part of the record.[1] You proceed. Why do we not set it for 10? We will not hold you to it but just so we get everybody in and ask everybody some questions. Please proceed.

STATEMENT OF DR. JACK CARLSON, EXECUTIVE OFFICER AND CHIEF ECONOMIST, NATIONAL ASSOCIATION OF REALTORS

Dr. **Carlson**. I am pleased to testify on behalf of the National Association of Realtors and to commend many of you on this panel, including you, Senator, and also Senator Johnston and Senator Exon, on your leadership to try to bring the deficit down in the past.

POSITIONS OF PRESIDENT NAR AGREES WITH

We agree with the following positions of the President in his budget and economic message, quote, " * * * the threat of indefinitely prolonged high budget deficits threatens the continuation of the sustained noninflationary growth and prosperity. It raises a specter of sharply higher interest rates, choked off investment, renewed recessions, and rising unemployment. This specter must be laid to rest * * * " and " * * * a number of actions will be required to lay it to rest * * * I will submit a budget that can achieve [the] goal * * * to reduce further the growth of spending and to put the budget on a path that will lead to a balance between outlays and receipts." Such changes must be " * * * bipartisan * * * fair * * * prudent * * * realistic." A "constitutional amendment" and a "line item veto" will be helpful. The process to reduce the budget should start in 1984 with a "downpayment. Our tax system [should] stimulate greater economic growth and provide more revenues."

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[1] See p. 305.

PROPOSALS AND ACTIONS OF PRESIDENT NAR DISAGREES WITH

However, we disagree with the President's budget and economic proposals and recent actions. One, the President did not exercise his current power to recommend substantial cuts in line items to be initiated in the fiscal year 1985 budget.

Two, the President did not use his existing constitutional powers to veto excessive appropriation bills during the fiscal 1984 budget cycle, even after he promised to do so.

Three, the President calls for a downpayment of deficit reduction that is too modest in relationship to the huge deficits. Only $14 billion from taxes and spending in fiscal year 1985 compared to $180 billion or higher deficit.

For the 3 years, fiscal 1985 to 1987, deficit reductions would be only $73 billion from the congressional baseline and compare unfavorably to the deficit of over $500 billion during the same time period.

Four, the President fails to specify the actions that would put the budget on a path to balance. Instead, he calls for delay until after the November elections so that American people will be unable to hold him or the Congress accountable.

Five, we are disappointed and appalled by the return of the paralysis of Government leadership which we witnessed during the first half of 1982. If a bipartisan effort is thwarted by cynical political maneuvers and the President and his party will not consider trimming the cuts in personal income taxes and the Speaker of the House of Representatives and his party will not consider trimming the growth of entitlements, then both incumbent Republicans and Democrats deserve the condemnation of the American people.

Six, the economic report and the budget document have rosy scenarios. I think the Congressional Budget Office in their testimony this morning in the other House indicated how overly optimistic they tend to be.

However, I would not want to throw away this document. There is some good scholarship in some of the chapters of the economic report of the President as well as the budget document.

We feel that the Federal Reserve Board's money supply growth targets that were announced yesterday may be too limiting particularly with uncertainty as to the acceleration in the use of money or velocity.

We prefer a modestly higher upper limit, perhaps 1 percentage point higher.

ECONOMIC IMPACT OF REAGAN'S PROPOSALS

Now, turning to the question you asked us. The impact of President Reagan's fiscal year 1985 budget proposals on the economy. We are convinced the President's budget and economic message are aimed at continuing record deficits for the foreseeable future, and I draw your attention to page 4 (figure 1) of my prepared statement,[1] that gives you a pictorial where we think the deficits will go with his economic message.

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[1] See p. 308.

Such huge deficits will continue to take three-quarters or more of the net savings, and by the way, last year it was 107 percent. The net savings of the American people and business, this has never occurred prior to 1982 in the peacetime history of the United States or among other industrialized countries.

DEFICITS AS PERCENT OF SAVINGS

And I draw your attention to figure 2 [1] and notice 77 percent in 1982. The key thing is not the deficits as a percent of GNP, but the deficits as a percent of savings within these countries, and you can see how far out of line the United States is in relationship to other countries, and consequently why the real interest rates are higher. in the United States.

These huge Federal deficits are causing over one-half of the current long-term interest rates and are forecast to cause an even higher proportion if deficits are not reduced.

It is interesting to note that the scholarship on page 6 (figure 3) [2] that is shown in that particular table came from some pioneering work of Martin Feldstein and Otto Eckstein many years ago, and we built upon that analysis to provide the assessments to you.

REAL INTEREST RATES

Persistent deficits are likely to continue to cause high real interest rates for a long period of time, double the average of the last 30 years, and you can see that on page 7 (figure 4) [3]. This is a different world. We have not had this before.

During the second and third year of a recovery from a recession, investment expenditures to increase the capacity for the economy to continue to grow usually becomes a larger proportion of total spending. However, high persistent real interest rates are damping, and are forecast to continue damping, this normal improvement during 1984 and 1985, the second and third years of this recovery.

The tax changes of 1981 and 1982, aimed at encouraging domestic investment, are and can only partially offset the huge increase in real interest rates. In effect, we have not had the ability to have the stimulating effect of those tax changes because of the increase in real interest rates.

Higher and persistent real interest rates are causing an overvaluation of the U.S. dollar which, in turn, acts as a 30-percent-plus excise tax on U.S. exports and a 30-percent import subsidy for foreign goods and services, thus crippling many highly productive industries and exporting jobs abroad.

Also, high real interest rates are creating too great a reliance on the resulting flow of foreign funds which is equivalent, at the present, to about one-half of net private investment. The flow could change abruptly and create even greater shortages of private investible funds and drive interest rates even higher.

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[1] See p. 309.

[2] See p. 310.

[3] See p. 311.

PACE OF RECOVERY MAY SLOW

Because of record deficit-caused real interest rates, the pace of recovery may slow and the duration will likely be shorter as the President acknowledges in his report.

The next recession or very slow growth period could start by the end of 1985 or during 1986 as shown on paqe 9 (figure 5)[1]. Similarly the unemployment rate could increase. Household income would follow a similar pattern.

Unlike the administration, we believe that inflation will accelerate to about 6 percent by 1985. That is higher than the administration but closer to the CBO estimate. We expect even higher inflation in subsequent years as skilled workers and capacity shortages appear and wage demands increase.

Given the Federal Reserve's objective of controlling inflation, we believe the Federal Reserve's policy will be less accommodating over this period than is implicitly assumed in the administration's economic projections.

COMPARISON OF ECONOMIC RECOVERIES

In any case, it is unlikely that the administration's forecast will be achieved even with more neutral monetary policy which we recommend. During peacetime there has never been as long a recovery as the administration promises, and you can see all of the recoveries we've had for the last 30 years on page 12 (figure 8)[2].

The administration is indicating that it will be at least 28 months. The average of other recoveries has been 13 months. There has been none over 20 months, except for the one in the latter part of 1960's which was driven by the Vietnam war.

STRATEGY TO REDUCE BUDGET DEFICITS

Rather than follow the President's proposals to do very little about the huge deficits that threaten the jobs and income of Americans we strongly recommend that a program of deficit reduction be enacted during 1984 and be designed to reduce excessive deficits each year until it is eliminated by the end of the 1980's at high employment.

We recommend the following as being bipartisan, fair, prudent, and realistic. One, limit growth in defense outlays to inflation plus 5 percent.

Two, limit growth in nondefense spending, excluding entitlements, to no more than the inflation rate. Three, limit the adjustment that increases social security, Federal retirement and other entitlements, and that automatically cuts personal income tax rates—or indexation—to less than the increase in the Consumer Price Index, preferribly CPI minus 3 percent or 60 percent of the CPI increase.

Limiting the adjustment for benefit increases and personal income tax decreases could be done in one act so that spending cuts and tax increases could be implemented simultaneously, which is rather important for the Congress.

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[1] See p. 313.

[2] See p. 316.

We support reform of the tax system to foster more adequate savings and investment for education, training, housing, business, and industrial plant and equipment. We support a constitutional amendment to make it more difficult to create and maintain massive and harmful deficits in the future.

Also we support the President's having additional line item veto authority. However, we recognize that tax reform or a constitutional amendment could take many years before they become law and are implemented. This could be helpful in the 1990's. Line item veto authority would affect only a small proportion of spending. For example, it would not apply to entitlements. Also, it would not apply to taxes. It should be considered as only supplementary to more powerful efforts to limit the deficit.

IMPACT ON DEFICIT USING CPI THREE-FOR-ALL

CPI minus 3 or "3-for-all" as we call it would be fair for all since a small sacrifice would be asked for most Americans. Upper income tax payers and lower income entitlement benefit receivers. A small sacrifice by most would result in a greater benefit for all in the years ahead.

Slowing the growth of Government benefits and trimming personal income tax cuts would slow the growth of consumption so that more funds would be invested in education, housing, and business so that the American standard of living would be higher in the future.

The overstatement of inflation and loss of purchasing power as measured by the defective Consumer Price Index could be offset. Three-for-all together with limits on the growth of defense and other nondefense spending could balance the Federal budget at high employment in 6 years, and we have our figures to show you the impact on the deficit on page 15 (figure 9)[1] of both the CPI minus 3 which gets you your balance in 6 years or more modest CPI minus 2 and minus 1.

DECLINE IN LONG-TERM INTEREST RATES WITH LOWER DEFICITS

As the deficit is reduced with a known and believable commitment to a path toward a balanced budget at high employment, real long-term interest rates would decline rapidly during the initial months and then continue to decline.

If a deficit reduction downpayment and known installments were enacted by May, real long-term interest rates could be down 1 full percentage point by November and more than 3 percentage points when fully implemented, and I draw your attention to page 17 (figure 10)[2] to show you the profile of the decline in real interest rates.

Investments would accelerate and the stockmarket would climb. This would be in sharp contrast to the increase in interest rates and the decline in the stockmarket as a reaction to the President's budget and economic proposals and the inaction of the Congress.

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[1] See p. 319.
[2] See p. 321.

Lower deficits, causing lower interest rates, would result in greater savings, investment, productivity, output, jobs, and income, an extension of the recovery as shown on page 18 (figure 11).[1] The benefits would be realized by every State in the Union including the States represented on this panel.

In conclusion, the effects of the President's economic budget proposal is bad for the long-term economic health of the United States. The President and the Congress must end current paralysis in Government leadership and enact policies to lower the deficit to a balance within the next 6 years.

We recommend the 3-for-all as the most effective and feasible strategy: CPI minus 3 for adjusting entitlements and personal income tax rates, with 5 percent real growth of defense spending, and no growth of nondefense spending.

Thank you, Mr. Chairman.

[The prepared statement of Dr. Carlson follows:]

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[1] See p. 322.

STATEMENT
on behalf of the
NATIONAL ASSOCIATION OF REALTORS®
regarding
FIRST CONCURRENT BUDGET RESOLUTION FOR FY 1985
to the
SENATE COMMITTEE ON THE BUDGET
by
DR. JACK CARLSON
February 7, 1984

I am Jack Carlson, Executive Officer and Chief Economist of the NATIONAL ASSOCIATION OF REALTORS®. On behalf of the more than 600,000 members of the National Association, we greatly appreciate the opportunity to testify before the Senate Committee on the Budget as you consider the First Concurrent Budget Resolution for FY 1985. We are pleased to respond to this Committee's request for our views on (1) the effect of the President's FY 1985 budget proposals on the economy, and (2) strategies to reduce budget deficits over the next several years.

We agree with the following positions of the President in his budget and economic messages:

- "...the threat of indefinitely prolonged high budget deficits threatens the continuation of sustained non-inflationary growth and prosperity. It raises the specter of sharply higher interest rates, choked-off investment, renewed recession, and rising unemployment."
- "This specter must be laid to rest...." and "...A number of actions will be required to lay it to rest."
- "...I will submit a budget that can achieve [the] goal..." "...to reduce further the growth of spending and to put the budget on a path that will lead to a balance between

outlays and receipts."

- Such changes must be "...bipartisan...fair...prudent... realistic."
- A "Constitutional Amendment" and a "line item veto" will be helpful.
- The process to reduce the budget should start in 1984 with a "down payment."
- "Our tax system [should] stimulate greater economic growth and provide more revenues."

We disagree with the President's budget and economic proposals and recent actions:

(1) The President did not exercise his current power to recommend substantial cuts in "line items" to be initiated in the FY 1985 budget.

(2) The President did not use his existing Constitutional powers to veto excessive appropriation bills during the FY 1984 budget cycle, even after he promised to do so.

(3) The President calls for a "down payment" of deficit reduction that is too modest in relation to the huge deficit -- only $14 billion from both taxes and spending in FY 1985 compared to a $180 billion or higher deficit; for the three years FY 1985-87, deficit reductions would total only $73 billion from the Congressional baseline and compare unfavorably to the deficit of over $500 billion during the same time period.

(4) The President fails to specify the actions that would put the budget on a path to balance. Instead, he calls for delay until after the November elections so that the American people will be unable to hold him (or the Congress) accountable.

(5) We are disappointed and appalled by the return of the paralysis of government leadership which we witnessed during the first half of 1982. If a bi-partisan effort is thwarted by cynical political maneuvers and the President and his party will not consider trimming the cuts in personal income taxes and the Speaker of the House of Representatives and his party will not consider trimming the growth of entitlements, then both incumbent Republicans and Democrats deserve the condemnation of the American people.

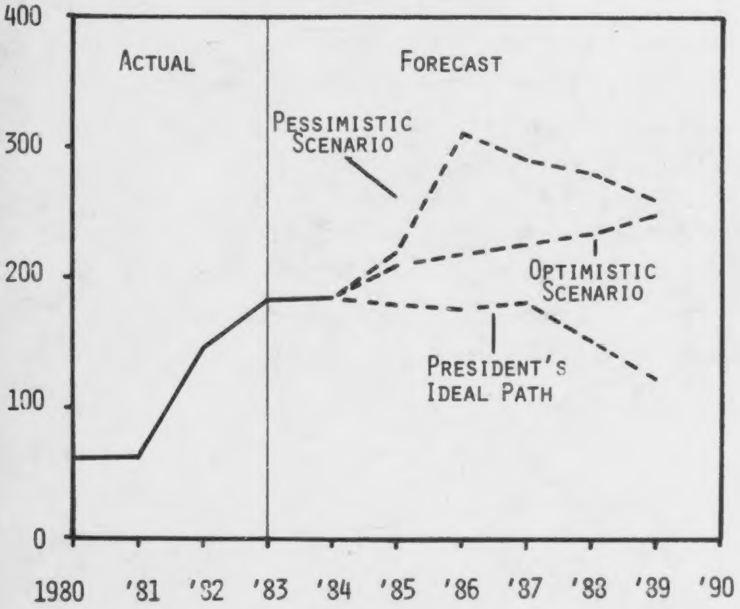
We feel that the Federal Reserve Board's money supply growth targets may be too limiting, particularly with uncertainty as to acceleration in the use of money (velocity). We prefer a modestly higher upper limit -- 0.5 to 1 percentage point.

IMPACT OF PRESIDENT REAGAN'S FY 1985 BUDGET PROPOSALS ON THE ECONOMY

In response to Chairman Domenici and Senator Chiles, we are convinced the President's Budget and Economic Messages are aimed at continuing record deficits for the foreseeable future (see Figure 1).

FIGURE 1

FEDERAL DEFICIT
(CALENDAR YEAR, NIA BASIS)



Source: NATIONAL ASSOCIATION OF REALTORS®.

Such huge deficits will continue to take three-quarters or more of the net savings of the American people and business. This has never occurred prior to 1982 in the peacetime history of the United States or among other industrialized countries (see Figure 2).

FIGURE 2

CENTRAL GOVERNMENT DEFICITS AS PERCENTAGE OF GNP AND PRIVATE SAVINGS AND RESULTING REAL INTEREST RATES 1982

	Central Government Deficit as a Percent of GNP 1/	Central Government Borrowing as a Percent of Net Private Domestic Savings 2/ of individuals and business	Real Long-Term Interest Rates 3/
United States	4.3	$\boxed{77}$	5.3
United Kingdom	2.8	58	4.6
Japan	5.8	41	3.9
France	2.8	40	3.8
Germany	2.6	29	3.4

1/ Source: International Monetary Fund.
2/ Source: International Monetary Fund. Net private savings is defined as household saving plus gross savings of business enterprises, subtracting depreciation charges and other capital consumption allowances.
3/ Computed assuming the rate of growth of money supply is equal in all countries.

These huge federal deficits are causing over one-half of current long-term interest rates (see Figure 3) and are forecast to cause an even higher proportion if deficits are not reduced.[1]

FIGURE 3

CURRENT CAUSE OF HIGH MORTGAGE INTEREST RATES
(Fourth Quarter 1983)

	Percentage Points		Percent of Total	
Fiscal Policy - Deficit		7.6		57
Current Crowding Out	1.1		8	
Inflation fears -- Future Crowding Out	6.5		49	
Monetary Policy Money Growth		5.8		43
ACTUAL INTEREST RATE		13.4		100

Source: Testimony of Jack Carlson debating the Treasury Department on "The Relationship Between Federal Deficits and Interest Rates", October 21, 1983. The estimates are based on an extension and update of several studies and additional empirical analysis by Martin S. Feldstein and Otto Eckstein, "The Fundamental Determinants of the Interest Rate", The Review of Economics and Statistics, November 1970, pp. 363-375.

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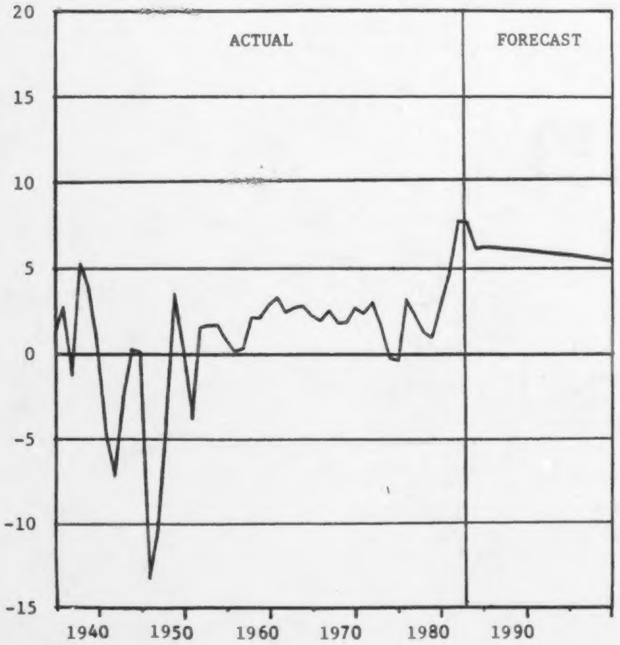
[1] Estimates were provided to the Joint Economic Committee, October 21, 1983, in a debate between Jack Carlson and the Treasury Department concerning "The Relationship Between Federal Deficits and Interest Rates."

Persistent deficits are likely to continue to cause high real interest rates for a long period of time, double the average of the last 30 years (see Figure 4).

FIGURE 4

REAL INTEREST RATES [1/]



1/ AAA Corporate bond rate, adjusted for inflation by the GNP price deflator (1935-2000).

Sources: Actual data from the Bureau of the Census, Historical Statistics: Colonial Times to 1970, and Moody's Investors Service. Forecast from the NATIONAL ASSOCIATION OF REALTORS® based on a simulation of the Data Resources Inc. long-term annual model of the U.S. economy.

During the second and third year of a recovery from a recession, investment expenditures to increase the capacity for the economy to continue to grow usually become a larger proportion of total spending. However, persistently high real interest rates are dampening and are forecast to continue dampening this normal improvement during 1984 and 1985, the second and third years of this recovery.

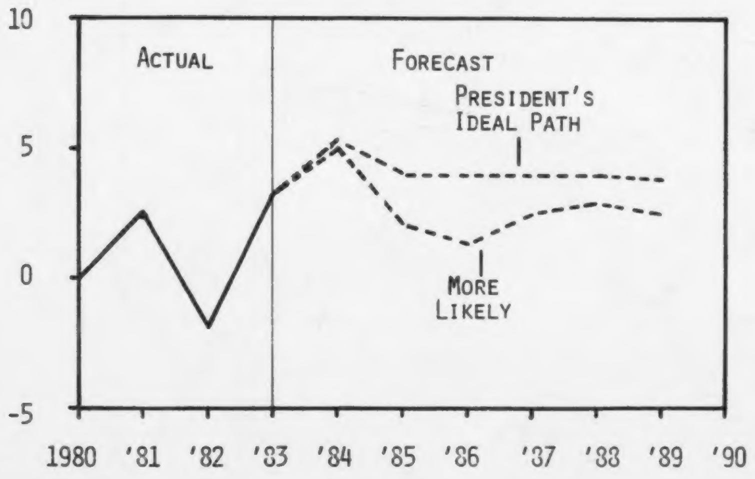
The tax changes of 1981 and 1982 aimed at encouraging domestic investment are and can only partially offset the huge increase in real interest rates.

High and persistent real interest rates are causing an over-valuation of the U.S. dollar which, in turn, acts as a 30% excise tax on U.S. exports and a 30% import subsidy for foreign goods and services, thus crippling many highly productive industries and exporting jobs abroad. Also, high real interest rates are creating too great a reliance on the resulting flow of foreign funds, which is equivalent to about one-half of net private investment. The flow could change abruptly and create even greater shortage of private investable funds and drive interest rates even higher.

Because of record, deficit-caused real interest rates, the pace of recovery may slow and the duration likely will be shorter. The next recession or very slow growth period could start by the end of 1985 or during 1986 (see Figure 5).

FIGURE 5

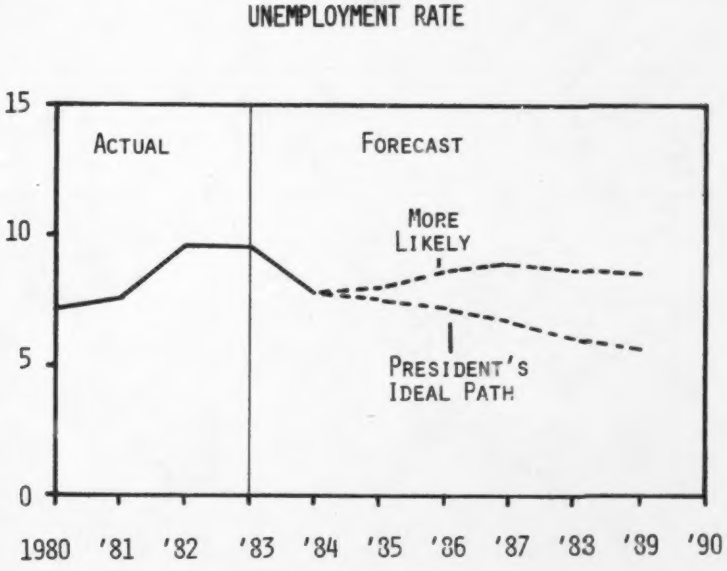
PERCENTAGE CHANGE IN REAL GNP



Source: NATIONAL ASSOCIATION OF REALTORS®.

Similarly, the unemployment rate could increase (see Figure 6).

FIGURE 6

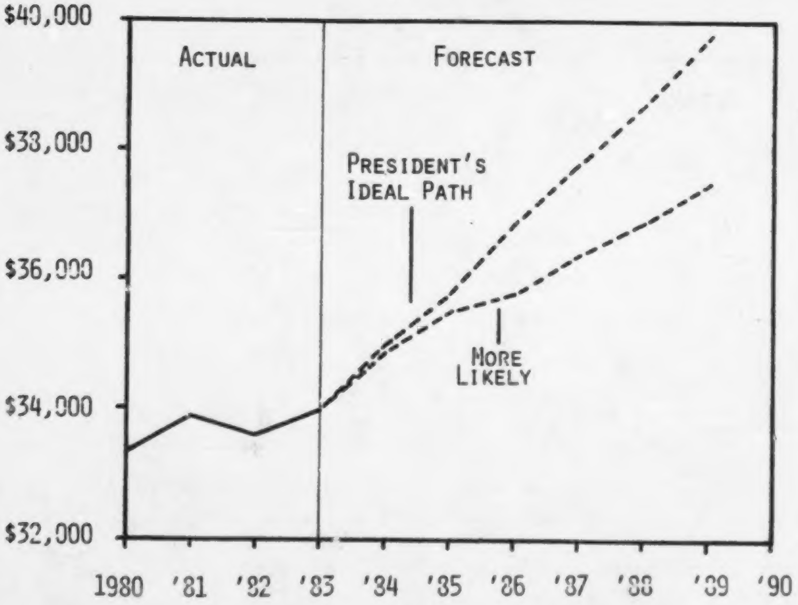


Source: NATIONAL ASSOCIATION OF REALTORS®.

Household income would follow a similar pattern (see Figure 7).

FIGURE 7

REAL INCOME PER HOUSEHOLD
(BASE 1983)



Source: NATIONAL ASSOCIATION OF REALTORS®.

Unlike the Administration, we believe that inflation will accelerate to about 6 percent by 1985 and even higher in subsequent years as skilled workers and capacity shortages appear and wage demands increase. Given the Federal Reserve's objective of controlling inflation, we believe that Fed policy will be less accommodating over this period than is implicitly assumed in the Administration's economic projections.

In any case, it is unlikely that the Administration's forecast will be achieved even with more neutral monetary policy. During peacetime there has never been as long a recovery as the Administration promises (see Figure 8).

FIGURE 8

DURATION AND STRENGTH OF
ECONOMIC RECOVERIES DURING PEACETIME
COMPARED WITH ADMINISTRATION'S PROJECTION

TROUGH	PEAK	DURATION	% CHANGE IN REAL GNP	AVERAGE ANNUAL % CHANGE IN REAL GNP
		Administration's Projection		
82:4	89:4	28 quarters	32.4	4.1
		Average of last 30 Years		
		13 quarters	16.6	4.8
		Peacetime Recoveries		
80:2	81:3	5 quarters	4.4	3.5
75:1	80:1	20 quarters	24.3	4.4
70:4	73:4	12 quarters	16.7	5.3
60:4	65:4[1/]	20 quarters	29.7	5.3
58:1	60:1	8 quarters	11.3	5.5
54:2	57:3	13 quarters	13.2	3.9

[1/] After 65:4, stimulus came from the Vietnam War and caused continuous growth and a doubling of the higher inflation rate until 69:3.

Source: NATIONAL ASSOCIATION OF REALTORS®.

STRATEGY TO REDUCE BUDGET DEFICITS AND IMPROVE ECONOMIC OUTLOOK

Rather than follow the President's proposals to do very little about the huge deficits that threaten the jobs and income of Americans, we strongly recommend that a program of deficit reduction be enacted during 1984 and be designed to reduce excessive deficits each year until deficits are eliminated by the end of the 1980's at high employment.

We recommend the following as being "bi-partisan, fair, prudent and realistic":

(1) Limit growth in defense outlays to inflation plus 5 percent.

(2) Limit growth in non-defense spending (excluding entitlements) to no more than the inflation rate.

(3) Limit the adjustment (a) that increases social security, federal retirement and other entitlements, and (b) that automatically cuts personal income tax rates (indexation) to less than the increase in the Consumer Price Index (CPI) -- preferably CPI-3 or 60 percent of the CPI increase.

Limiting the adjustment for benefit increases and personal income tax rate decreases could be done in one act so that cuts in spending growth and tax increases could be implemented simultaneously.

We support reform of the tax system to foster more adequate saving and investment for education, training, housing, business and industrial plant and equipment.

We support a Constitutional Amendment to make it more difficult to create and maintain massive and harmful deficits in the future. Also, we support the President having additional line item veto authority.

However, we recognize that tax reform or a Constitutional Amendment would take many years before becoming law and being implemented. This could be helpful in the 1990's. Line item veto authority would affect only a small proportion of spending; for example, it would not apply to entitlements. Also it would not apply to taxes. It should be considered as only supplementary to more powerful efforts to limit the deficit.

CPI-3 or THREE-FOR-ALL would be fair-for-all since a small sacrifice would be asked from most Americans: from upper income taxpayers to lower income entitlement benefit receivers. A small sacrifice by most would result in greater benefits for all in the years ahead.

Slowing the growth of government benefits and trimming personal income tax cuts would slow the growth of consumption so that more funds could be invested in education, housing and business and the American standard of living could be higher in the future.

The over-statement of inflation and loss of purchasing power as measured by the defective Consumer Price Index could be offset.

THREE-FOR-ALL, with limits on the growth of defense and other non-defense spending, could balance the Federal budget at high employment in six years (see Figure 9).

FIGURE 9

REDUCTIONS IN THE FEDERAL DEFICIT FROM ALTERNATIVE PROPOSALS FOR LIMITING THE GROWTH IN ENTITLEMENTS AND CUTS IN PERSONAL INCOME TAX RATES 1/

(NIA Basis, Billions of Dollars)

	1985			1987			1989		
	CPI Minus 3	CPI Minus 2	CPI Minus 1	CPI Minus 3	CPI Minus 2	CPI Minus 1	CPI Minus 3	CPI Minus 2	CPI Minus 1
Expected Deficit	$-210	$-210	$-210	$-228	$-228	$-228	$-249	$-249	$-249
Impact on:									
Revenues	12	7	2	45	25	11	85	50	23
Direct	1	1	0	15	10	5	40	27	13
Induced	11	6	2	30	15	6	45	23	10
Expenditures	-19	-11	-5	-45	-24	-10	-100	-56	-23
Transfer Payments	-10	-7	-3	-14	-9	-4	-37	-24	-11
Direct	-9	-6	-3	-12	-8	-4	-26	-18	-9
Induced	-1	-1	0	-2	-1	0	-11	-6	-2
Net Interest	-9	-5	-2	-31	-15	-6	-63	-32	-12
Deficit	-31	-18	-7	-90	-49	-22	-185	-106	-46
Resulting Deficit	-179	-192	-203	-138	-179	-206	-64	-143	-203

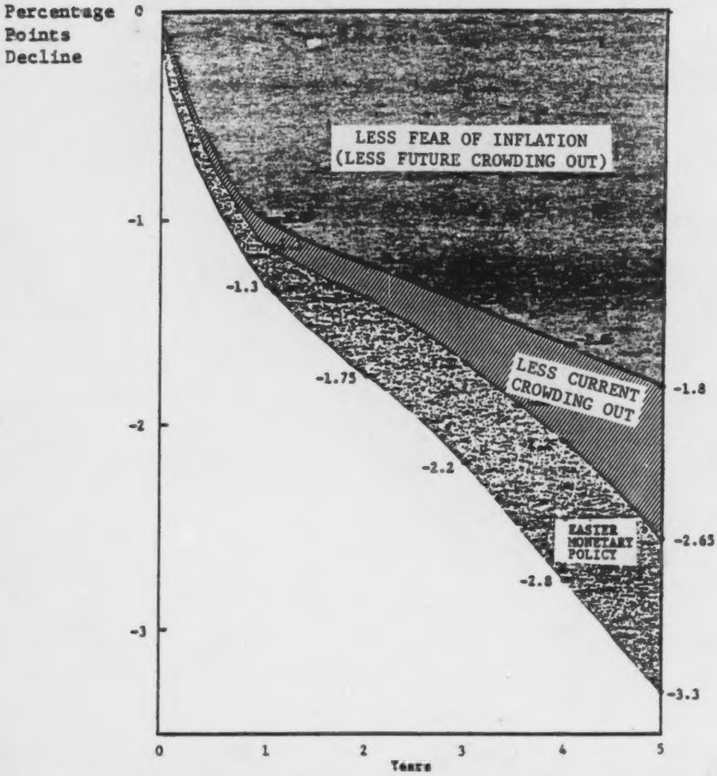
1/ Table assumes 5 percent real growth in defense spending and growth in non-defense spending (excluding entitlements) equal to the projected rate of inflation.

Source: NATIONAL ASSOCIATION OF REALTORS®.

As the deficit is reduced with a known and believable commitment to a path toward a balanced budget at high employment, real long-term interest rates would decline rapidly during the initial months and then continue to decline. If a deficit-reduction "down payment" and known installments were enacted by May, real long-term interest rates could be down 1 full percentage point by November and by more than 3 percentage points when fully implemented (see Figure 10). Investment would accelerate and the stock market would climb. This would be in sharp contrast to the increase in interest rates and decline in the stock market as a reaction to the President's budget and economic proposals and inaction of the Congress.

FIGURE 10

DECLINE IN LONG-TERM INTEREST RATES WITH LOWER DEFICITS FROM THREE-FOR-ALL (CPI-3) 1/



1/ Based on an extension and update of empirical analysis and synthesis by Martin S. Feldstein, "The Fundamental Determinants of the Interest Rate," The Review of Economics and Statistics, November 1970, pp. 363-375.

Source: Testimony of Jack Carlson before the Joint Economic Committee debating the Treasury Department on "The Relationship Between Federal Deficits and Interest Rates", October 21, 1983. The estimates are based on an extension and update of previous studies reported and additional empirical analysis by Martin S. Feldstein and Otto Eckstein, "The Fundamental Determinants of the Interest Rate," The Review of Economics and Statistics, November 1970, pp. 363-375.

Lower deficits causing lower interest rates would result in greater savings, investment, productivity, output, jobs and income and an extension of the recovery (see Figure 11). The benefits would be realized by every state in the Union (see Figure 12).

FIGURE 11

ECONOMIC IMPACTS OF ALTERNATIVE PROPOSALS
FOR LIMITING GROWTH OF ENTITLEMENTS AND CUTS IN PERSONAL
INCOME TAX BRACKETS

	1985			1987			1989		
	CPI Minus 3	CPI Minus 2	CPI Minus 1	CPI Minus 3	CPI Minus 2	CPI Minus 1	CPI Minus 3	CPI Minus 2	CPI Minus 1
GNP ($84 billion)	13.5	6.8	2.7	113.9	57.0	22.8	178.3	89.2	35.7
Percent (%)	0.4	0.2	0.1	3.1	1.6	0.6	4.5	2.3	0.9
Residential Investment ($84 billion)	6.5	3.3	1.3	38.6	19.3	7.7	82.4	41.2	16.5
Percent (%)	4.4	2.2	0.9	24.6	12.3	4.9	46.7	23.4	9.3
Nonresidential Investment ($84 billion)	0.8	0.4	0.2	14.7	7.4	2.9	46.9	23.5	9.4
Percent (%)	0.2	0.1	0.0	3.7	1.9	0.7	10.8	5.4	2.2
Structures ($84 billion)	0.5	0.3	0.1	8.0	4.0	1.6	24.1	12.1	4.8
Percent (%)	0.4	0.2	0.1	5.2	2.6	1.0	14.0	7.0	2.8
Equipment ($84 billion)	0.3	0.2	0.1	6.8	3.4	1.4	22.8	11.4	4.6
Percent (%)	0.1	0.1	0.0	2.8	1.4	0.6	8.7	4.4	1.7
Income per Household ($84)	100	50	20	860	430	172	1800	900	500
Percent (%)	0.3	0.2	0.1	1.7	0.9	0.3	3.0	1.5	0.6
Total Private Savings ($84 billion)	12.0	6.0	2.4	25.4	12.7	5.1	25.8	12.9	5.2
Percent (%)	1.9	0.9	0.4	3.8	1.9	0.8	4.3	2.2	0.9
Employment (millions of jobs)	0.30	0.15	0.06	1.4	0.7	0.3	2.2	1.1	0.4
Long-term Interest Rates (e.g. Mortgage Interest Rates) (Percentage Points)	- 1.3	-0.7	-0.3	-2.3	-1.2	-0.5	-3.3	-1.7	-0.7
New Home Starts (thousands of units)	195	98	39	500	250	100	650	325	130
Existing Home Sales (thousands of units)	350	175	70	1000	500	200	1200	600	240
Domestic Car Sales (thousands of units)	260	130	52	800	400	160	1500	750	300

Source: NATIONAL ASSOCIATION OF REALTORS®.

FIGURE 12
IMPACT OF THE THREE-FOR-ALL PROGRAM WHEN FULLY IMPLEMENTED BY STATE

State	Increase in Permanent Jobs	Increase in Income per Household (annual)	Households satisfying New and Existing Home Needs (annual)
Alabama	42,600	1,300	25,400
Alaska	6,300	2,300	8,400
Arizona	20,600	1,500	33,200
Arkansas	20,400	1,300	23,200
California	201,500	1,900	141,300
Colorado	23,000	1,800	20,600
Connecticut	36,400	2,100	14,800
Delaware	4,900	1,900	5,700
District of Columbia	3,200	2,200	3,600
Florida	65,400	1,600	101,300
Georgia	44,500	1,400	50,200
Hawaii	4,800	1,800	4,400
Idaho	8,800	1,400	6,500
Illinois	89,500	1,900	61,900
Indiana	65,400	1,600	29,800
Iowa	21,000	1,600	22,700
Kansas	22,100	1,800	24,600
Kentucky	30,800	1,400	29,000
Louisiana	34,000	1,600	50,400
Maine	9,400	1,400	9,800
Maryland	30,500	1,800	44,600
Massachusetts	42,800	1,800	29,000
Michigan	119,300	1,700	68,800
Minnesota	35,600	1,700	42,800
Mississippi	23,300	1,200	23,500
Missouri	39,600	1,600	32,800
Montana	6,400	1,600	5,600
Nebraska	11,100	1,600	16,600
Nevada	4,500	1,800	8,000
New Hampshire	8,700	1,600	6,600
New Jersey	51,700	1,900	77,800
New Mexico	9,700	1,400	13,300
New York	102,100	1,900	63,200
North Carolina	69,000	1,400	77,600
North Dakota	3,900	1,600	6,700
Ohio	125,600	1,700	62,300
Oklahoma	22,600	1,700	51,900
Oregon	34,400	1,600	17,300
Pennsylvania	108,800	1,600	68,100
Rhode Island	7,100	1,700	3,900
South Carolina	33,800	1,300	28,100
South Dakota	3,500	1,300	8,200
Tennessee	44,700	1,400	37,800
Texas	130,100	1,800	144,300
Utah	11,900	1,300	10,300
Vermont	4,600	1,400	5,700
Virginia	47,900	1,700	67,700
Washington	48,400	1,800	27,800
West Virginia	13,900	1,400	14,600
Wisconsin	44,500	1,600	26,500
Wyoming	5,500	1,800	5,700
U.S.	2,200,000	1,800	1,850,000

Source: Model developed by the NATIONAL ASSOCIATION OF REALTORS® and Data Resources, Inc. Assumptions and simulations by Dr. Jack Carlson, Hugh Graham and Dick Peach.

In conclusion, the effect of the President's Economic and Budget proposals is bad for the long-term economic health of the United States. The President and the Congress must end the current paralysis in government leadership and enact policies to lower the deficit to a balance within the next six years. We recommend the THREE-FOR-ALL program as the most effective and feasible strategy -- CPI-3 for adjusting entitlements and personal income tax rates, with 5% real growth of defense spending and no real growth of non-defense spending.

Chairman **Domenici.** I am going to let Senator Exon break our pattern here, since he has been very faithful and must go to Armed Services. I am going to yield for 5 minutes.

Senator **Exon.** Mr. Chairman, thank you very much. I do not intend to take that long. I have to go to Armed Services.

Gentlemen, I want to welcome you here. We do not have this place full of cameras or people, but I have always felt that the testimony from the organizations that you represent, the realtors, the homebuilders, the Association of Manufacturers, and the Federation of Independent Business, have always given us some of the best testimony that we receive in this committee. It is commonsense. It is down to Earth. And it is what all of us on this committee would like to do.

ATTACK DEFICIT PROBLEM WITH INCREASED REVENUES

I have just one question that maybe you could each comment on a little bit. I think that, if we realistically look at the situation that confronts us, and that is the deficit problem and skyrocketing national debt, there is no way that we are ever going to be able to attack those problems under any realistic set of circumstances that we could sell to the majority of the Congress or to the President of the United States. Therefore, if we are going to do something about that, we are going to have to have some increased revenue, revenue enhancements, taxes, call it what you will.

Now, the problem that I find that the people of Nebraska are saying is that nobody wants to pay more taxes but, if you did raise my taxes and if you had some kind of a system, you could invent some kind of a system to make sure that my taxes would go to attack the problem that Jack Carlson just talked about—and I appreciate your opening statement. Most of us on this committee have worked very closely with you and your organization, and the rest are trying to do something about this.

What I am saying is that the people out home are saying don't raise my taxes to spend more money.

DEDICATE REVENUE ENHANCEMENTS TO DECREASING THE DEFICIT

I have been searching for this ever since I have been here. Is there any way or have your organizations ever come up with any kind of an idea where we could dedicate any new taxes or revenue enhancements to, No. 1, decreasing the deficits? Or, if you want to take it a step back from that, reducing the national debt, that nobody ever talks about, and that is the central problem when you really look at it. If we are going to have something like that that would be workable, we would also, it seems to me, have to put some kind of a cap on what we are going to spend. Otherwise, if we raise taxes to reduce the debt here and continued with $200 or $250 or a $300 billion deficit, as I can see in the out-years right now, we would be reducing it here but would be slipping it in from the side over here, and it would go up.

I have often called this a ratchet effect. If we could invent a system where there would be a ratchet, that we just would not spend any more money unless the President and the Congress had the courage to go to the people and say: OK, I'm going to spend this for social programs, or I'm going to spend this for defense. But I am also going to tax you to do it.

We had to do that in Nebraska the 8 years I was Governor. It worked pretty well. I think there is nothing more effective than holding down both taxation and expenditures, by having the people who spend the money or authorize the spending of the people in a given period of time also being the ones that have to say. "yes," and this is what we are going to tax you to do it. It is a great leveler.

Have you ever given any thought to any kind of a mechanism that might begin to work in that area? If any of you care to respond, I would like to hear it.

BROAD-BASED SURTAX SUGGESTED

Mr. **Herder**. I would like to respond. I think, No. 1, we have to get to the place where we may not have to spend any more. We had an interesting suggestion from one of our members that said maybe we should have a broad-based surtax and we should mail out the surtax bill on November 1 of every year, just before election day. This would call attention to what we are really talking about.

ONE ACT FOR BOTH TAX AND SPENDING SIDES

Dr. **Carlson**. On a complete basis, I do not have a suggestion. But on at least half of the spending side and nearly half of the taxing side, if you have one act by which you can limit the growth in benefits on entitlements and also can dampen the effect of indexing, you can take care of your tax and spending side. That is why CPI minus three—or two—or something like that has a lot of virtue.

What happened over a year ago—1982—is that you got the tax side, but you did not get the spending side. So, you have to have one act that carries it through the Congress. I think that has the virtue of doing that.

Also, it is surprising, it does not appear to be a tax increase, because it is less of a tax cut that is to automatically occur. There is a sensitivity on the Social Security side, and I think that is probably driving the debate at the present time.

As far as I know, that is about the best that you have, a packaging of across-the-board spending and taxing. It leaves out defense, so you have to figure out another mechanism that constrains defense. And nondefense seems to be pretty well constrained by what is written in the budget document.

TIE REVENUE INCREASES TO SPENDING CUTS

Mr. **Trowbridge**. Senator, I think that you have correctly identified the concern that many have about the prospect of increased revenues not being applied to solve the problem but indeed being used simply to provide more funds to be spent. There have been a number of recommendations. We would suggest they should be thoroughly looked at, that any such package that might be put together not have any tax increase go into effect until there has been an objective study made, perhaps by the Congressional Budget Office, that planned spending cuts have already occurred. In other words, tie any revenue increases to actual cuts in spending, as certified by an objective bipartisan organization.

RESTORE CONFIDENCE IN REDUCING THE DEFICIT

Mr. MOTLEY. Senator, I wish I had an answer for you. Maybe we should look at Nebraska for one. NFIB members in that State have consistently over the years voted for increased taxes for various different things. And that is probably because they felt somewhat assured that the money would be spent for specific subjects.

They do not feel the same about the Federal Government. And they do not particularly care for Jack's suggestion of CPI minus three, either. I think they do not feel that there are enough assurances involved in that.

The real problem seems to be a lack of confidence. I think if you find some way to restore that confidence that the money will go toward reducing the deficit, then you very well may find a little more interest within the small business community in paying additional taxes.

I agree with you 100 percent. I wish I could tell you how to do it.

Senator EXON. Thank you, gentlemen. I hope you will give that some thought. I really think if we could come up with a magical formula, we would maybe get on the road to doing what we all want to do.

Thank you, Mr. Chairman, I appreciate the courtesy.

Chairman DOMENICI. We are going to proceed now with the other witnesses in order.

I want to compliment you before I do go on, Dr. Carlson. While the deficit has gotten worse, the level of discussion has gotten better. The understanding of the budget has improved immensely, which your statement reflects. It is a deep understanding of where the problems are. I compliment you for your suggested solution.

Have your plans been priced out, either by the Congressional Budget Office or someone such that the statement about 6 years hence, where we will be, is accurate?

Dr. CARLSON. We do our own simulations, but we would be pleased to have anybody else compare those. We did have a debate in the Joint Economic Committee because we took issue with the Secretary of the Treasury's comment, and presented our documents there for Treasury review. As far as I know, they have no criticism of our projections of what the impact would be of our proposed way of getting the deficit down.

Chairman DOMENICI. Thank you very much. Our next witness is the president of the National Association of Home Builders. We welcome you. Would you proceed on the same basis, about 10 minutes?

STATEMENT OF PETER HERDER, PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. HERDER. Yes. Thank you, Mr. Chairman and members of the committee.

My name is Pete Herder. I am a homebuilder and developer from Tucson, Ariz. I am testifying on behalf of the more than 118,000 members of the National Association of Home Builders. NAHB is a trade association representing the Nation's homebuilding industry, of which I am president. Accompanying me today is John Koelemij, NAHB first vice president, and Bob Bannister, the senior staff vice president for government affairs.

Mr. Chairman, I wish to state at the outset that we applaud the President's recommendation to appoint a bipartisan working group to deal with the Federal deficit, and we strongly support focusing on the issue this year. We appreciate your efforts in scheduling these hearings and know well of your continued and longstanding work in focusing attention on deficit reduction.

We supported your efforts, and the efforts of Senator Chiles, to reduce the deficit last fall prior to adjournment. We look forward to working closely with this committee and its excellent, professional staff in seeking a bipartisan solution to deal with the budget issue this year.

DOWNPAYMENT

Mr. Chairman, we home builders and the homebuying public understand all too well the meaning of downpayment. Let me caution you, as we advise our buyers, that a low downpayment will only increase this Government's monthly payments. Young families and the poor will once again be priced out of the opportunity for homeownership and decent housing unless interest rates are reduced. A 10-percent downpayment is reasonable in the real estate business; I would propose a target of $92.5 billion reduction to the administration's fiscal year 1985 budget.

It is of no small significance that my first opportunity to testify before Congress as this association's president is on the Federal budget. We have shared your view that the budget deserves increased bipartisan attention and have developed, as you are aware, a national program using the theme of the Federal deficit as America's ticking time bomb. Our members feel so strongly about the budget and the resulting deficits that NAHB has embarked on a national, grassroots campaign to develop a broad consensus for action. As a result of this increased awareness among NAHB's membership and leadership that Federal budget deficits impact negatively on sustained economic growth and the continued health of this Nation's economy, we support action now, not in 1985. We support enactment of spending reductions as well as tax increases as needed to reduce the unprecedented $200 billion deficits.

To illustrate our members' commitment to action on the Federal deficit, I wish to share with you some of the results of a survey conducted in January of this year by our builders economic council.

CUT DOMESTIC SPENDING AND RAISE TAXES

When asked what should be done about the Federal budget deficit, a resounding 98 percent of the total favored "cut domestic spending," and 72 percent of the total favored "raise taxes," coupled with corresponding spending reductions.

Senator BIDEN. Seventy-two percent.

Mr. **Herder**. That is correct, Senator. To focus again on the administration's 1985 budget, we believe the President's proposed budget of $925 billion with a $180 billion deficit is too high. A $100 billion deficit reduction package as a downpayment to reduce the deficit is significant, however, in an election year. Such a downpayment should be viewed as a good-faith effort for further action. But I would like to emphasize that a downpayment implies just that, a downpayment, with the balance to follow. We would like to see bipartisan agreement on an even more substantial program. Because of the cyclical nature of our industry, we know only too well what dangers lie on the economic horizon. We firmly believe that the housing industry faces a severe downturn in calendar year 1985 without substantial action on the deficit this year.

BIPARTISAN COMPROMISE SUPPORTED

To maintain the current economic recovery at a healthy noninflationary pace, NAHB supports a bipartisan compromise on the following issues:

Domestic discretionary spending should be restricted.

The growth in entitlement programs must be scaled back and deindexed.

Increases in defense spending must be moderated.

Appropriate tax increases that will not abort the recovery should be instituted.

Federal Reserve monetary policy should provide for sufficient expansion of the money supply to accommodate economic growth.

There was an interesting article that appeared in the Washington Post this morning, "Fed to Slow Money Supply Growth from the 1983 Pace." It said the deficits already are keeping interest rates higher than they would be if the Government were borrowing less. The higher rates caused by this greater demand for credit are hurting housing and business investment. And we understand that fully. Mounting annual Government deficits have ballooned the Federal debt and increased interest payments to such a degree that interest now constitutes the third highest expenditure in the Federal Government, after national defense and income security. These mounting deficits will continue to strain the capacity of the Government merely to pay interest on the debt. Large projected deficits and the uncertainty of any future action to reduce them raise inflationary expectations. Even at a time of historically low current rates of inflation, a large interest premium is placed on long-term debt financing, especially home mortgages. This translates into higher housing costs for home buyers and a curtailment of needed investment in new rental housing.

HOUSING RECOVERY

The housing recovery which started in the final months of 1982 continued throughout 1983. In July 1983, conventional rates for newly constructed homes was 13.4 percent. By year's end, mortgage rates were an average 13.9 percent and were expected to subside only marginally in 1984. The housing industry did in fact lead economic recovery throughout 1983. Although investment in housing accounted for only about 3.4 percent of the Nation's real gross national product in 1983, housing was responsible for about 30 percent of total economic growth, or for $20 billion of the $70 billion real increase in GNP experienced during the year.

The approximately 1.7 million homes started in 1983 represent a 60-percent improvement from the 1.06 million unit annual production level in 1982. A production increase of 650,000 homes in 1983 from the prior year created 924,000 man-years of employment, $18 billion in wages, and $8 billion in local, State, and Federal taxes. The first year of the housing recovery pumped $86 billion in new activity into the economy.

SPECIFICS NEEDED TO BRING DEFICIT DOWN

As to the specifics needed to bring the deficit down, NAHB urges the Congress to adopt the operating premise that spending cuts and tax increases should be as broad based as possible. They should be fair in the sense of broadly affecting all income levels and sectors of the economy. On the revenue side, they should strive toward investment neutrality, not shift the relative attractiveness of capital from one economic sector to another, thereby altering the present mix of investment options.

NAHB has endorsed the Danforth-Boren, Jones-Campbell de-indexing proposals. NAHB also endorsed the general elements of the Finance Committee deficit-reduction package of 1983 which includes an energy consumption tax, a surtax on high income individuals, and a corporate surtax.

Another area of spending which needs to be examined is the overall domestic discretionary budget and the defense budget. As former President Gerald Ford stated during a debate on the deficit before our recent annual homebuilders convention in Houston, there exists no reason why 4-year defense contracts cannot be stretched to 5 years as a means of addressing the deficit.

MODIFY CURRENT TAX LAW

In the area of taxes, a great deal of discussion has been directed toward major restructuring of the tax code. NAHB urges Congress to delay consideration of major structural changes until 1985. What is needed at present is modification of the current law in as broad based a manner as possible to raise the revenues needed to reduce the Federal deficit. The implications of major restructuring remain unclear, and such changes should be the result of extensive debate and consideration.

We should continue to provide incentives to save in order to strengthen the capital base necessary for investment which is vital for sustained economic growth.

For individuals, proposals to cap the mortgage interest deduction or other tax benefits for housing would have a devastating effect on the housing market. On the business side, tax increases affecting real estate would accentuate current biases against business investment in real estate.

Finally, part of the Finance Committee deficit reduction measures and the administration's budget are directed toward tax shelters. These changes should be viewed with caution. For real estate investment, so-called tax shelters are a legitimate and necessary means of attracting needed capital.

In summary, we realize Congress and the administration cannot eradicate budget deficits overnight. We also agree that the economy continues to improve and our own forecasts for housing construction for 1984 look very favorable. However, we know better than most major industries the impact of interest rates on sustained long-term growth. Having undergone the most severe recession since World War II, we are now leading the recovery. But unless and until the deficits are dealt with by Congress and the administration, this recovery cannot last. The ticking time bomb is real.

Again, we look forward to working with you in any way you believe will be productive. Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you. Without objection, your written statement will be inserted.

[The prepared statement of Mr. Herder follows:]

STATEMENT OF
PETER HERDER
on behalf of the
NATIONAL ASSOCIATION OF HOME BUILDERS
before the
SENATE BUDGET COMMITTEE
on
FEBRUARY 7, 1984
on
FISCAL YEAR 1985 BUDGET

Mr. Chairman and Members of the Committee:

My name is Pete Herder and I am a home builder and developer from Tucson, Arizona.

I am testifying on behalf of the more than 118,000 members of the National Association of Home Builders (NAHB). NAHB is a trade association representing the nation's home building industry, of which I am President.

Accompanying me today is Robert D Bannister, Senior Staff Vice President for Government Affairs.

Mr. Chairman, I wish to state at the outset that we applaud the President's recommendation to appoint a bipartisan working group to deal with the federal deficit and we strongly support focusing on the issue this year. We appreciate your efforts in scheduling these hearings and know well of your continued and long-standing work in focusing attention on deficit reduction.

We supported your efforts, and the efforts of Senator Chiles, to reduce the deficit last fall prior to adjournment. We look forward to working closely with this committee and its excellent, professional staff in seeking a bipartisan solution to deal with the budget issues this year.

Mr. Chairman, we home builders and the homebuying public understand all too well the meaning of "downpayment." Let me caution you, as we advise our buyers, that a low downpayment will only increase this government's "monthly payments." Young families and the poor will once again be priced out of the opportunity for homeownership and decent housing unless interest rates are reduced. A 10 percent downpayment is reasonable in the real estate business; I would propose a target of $92.5 billion in reductions to the Administration's FY'85 budget this year.

It is of no small significance that my first opportunity to testify before Congress as this Association's President is on the federal budget. We have shared your view that the budget deserves increased bipartisan attention and have developed, as you are aware, a national program using the theme the federal deficit as America's "Ticking Time Bomb." Our members feel so strongly about the budget and the resulting deficits that NAHB has embarked on a national, grassroots campaign to develop a broad consensus for action. As a result of this increased awareness among NAHB's membership and leadership that federal budget deficits impact negatively on sustained economic growth and the continued health of this nation's economy we support action now, not in 1985. We support enactment of spending reductions as well as tax increases as needed to reduce the unprecedented $200 billion deficits.

To illustrate our membership's commitment to action on the federal deficit, I wish to share with you some of the results of a survey conducted in January of this year by our Builders Economic Council.

When asked "what should be done about the federal budget deficit" a resounding 98 percent of the total favored "cut domestic spending" and 72 percent of the total favored "raise taxes." Sixty-eight percent of those interviewed favor a combination of "cut spending" as well as "raise taxes." Only four percent favored the option of "do nothing, the economy's growth will close the deficit." Further only four percent favored "raise taxes" only, and only 25 percent favored "cut spending" only.

On the issue of tax increases, 43 percent of those favoring increased taxes support an increase in the corporate as well as the individual tax structure, 39 percent favor "sales" taxes, and 23 percent favor a "user fee" tax.

To focus again on the Administration's 1985 Budget, we believe the President's proposed budget of $925 billion with the $180 billion deficit is too high. A $100 billion plus deficit reduction package as a "downpayment" to reduce the deficit is significant, however, in an election year. Such a downpayment should be viewed as a good faith effort for further action. But, I would like to emphasize that a downpayment implies just that, "a downpayment," with the balance to follow. We would like to see bipartisan agreement on an even more substantial program. Because of the cyclical nature of our industry, we know only too well what dangers lie on the economic horizon. We firmly believe the housing industry faces a severe downturn in calendar year 1985 without substantial action on the deficit this year.

However, we feel a good faith effort on the part of Congress and the Administration in the form of a downpayment on the deficit should signal to the money markets and money managers the realization that the recovery will be long-term and sustained.

The prospects of an ever increasing deficit along with the political stalemate which has developed in the Congress and within the Administration have created mounting uncertainty about the ability of the economy to continue to grow beyond 1984 in a non-inflationary manner. The current economic situation demands bold and creative political leadership.

High interest rates will ultimately be a drag on the economy to the point where NAHB now sees a long-term sustained economic recovery in jeopardy.

To maintain the current economic recovery at a healthy, non-inflationary pace, NAHB supports a bipartisan compromise on the following issues:

° Domestic discretionary spending should be restricted;

- The growth in entitlement programs must be scaled back and de-indexed;
- Increases in defense spending must be moderated:
- Appropriate tax increases that will not abort the recovery should be instituted; and
- Federal Reserve monetary policy should provide for sufficient expansion of the money supply to accommodate economic growth.

Mounting annual government deficits, stacked each year on top of one other, have ballooned the federal debt and increased interest payments to such a degree that interest now constitutes the third highest expenditure in the federal government, after national defense and income security. These mounting deficits will continue to strain the capacity of the government merely to pay interest on the debt.

The more the debt grows, the higher the interest rates the Government has to pay to keep borrowing money, and servicing the debt becomes an increasing drain on the funds needed for economic growth.

Large projected deficits and the uncertainty of any future action to reduce them raise inflationary expectations. Even at a time of historically low current rates of inflation, a large interest premium is placed on long-term debt financing, especially home mortgages. This translates into higher housing costs for home buyers and a curtailment of needed investment in new rental housing.

The housing recovery, which started in the final months of 1982, continued throughout 1983. In July 1983 conventional rates for newly constructed homes was 13.4 percent. By years's end, mortgage rates were an average 13.9 percent and were expected to subside only marginally in 1984.

The housing industry did in fact lead economic recovery throughout 1983. Although investment in housing accounted for only about 3.4 percent of the nation's real gross national product in 1983, housing was responsible for about 30 percent of total economic growth, or for $20 billion of the $70 billion real increase in GNP experienced during the year. The approximately 1.7 million homes started in 1983 represent 60 percent improvement from the 1.06 million unit annual production level of 1982. New home sales rebounded sharply from 412,000 in 1982 to an estimated 625,000 -- a 52 percent gain. A production increase of 650,000 homes in 1983 from the prior year created 924,000 man years of employment, $18 billion in wages and $8 billion in local, state, and federal taxes. The first year of the housing recovery pumped $86 billion in new activity into the economy.

We expect the housing recovery to continue throughout 1984, with levels of activity comparable to those of 1983. However, even a relatively slight upward movement in interest rates could jeopardize the recovery, because mortgage rates remain just on the threshold of affordability for significant numbers of prospective buyers. It remains questionable, however, whether the recovery can continue beyond 1984 if, by then, annual federal deficits are still at their current annual level of about $200 billion. Economists are almost unanimous in their opinion that outsized federal deficits will inevitably clash with the capital needs of private borrowers, drive up interest rates, and abort the recovery. One reason for this is that at any given time during 1983, the federal government was borrowing half of the total credit available in the U.S. financial system, compared to only about 30 percent in 1980, 20 percent in 1970 and 5 percent in 1965.

Developing a consensus on budget issues will not be easy, but it is absolutely essential that Congress act now to reduce the federal deficit.

The need for action now is based upon a combination of factors. First and foremeost, the economy may not be able to sustain the growth necessary to continue to finance the government. Deficits in the out-years could exceed 300 billion dollars according to the latest CBO baseline projections. Despite the generally optimistic figures on housing starts and unemployment, the underlying health of the economy remains fragile. NAHB's housing affordability index, of which interest rates are a major factor, has shown a downward trend, evidence that potential home buyers are now being priced out of the housing market. A delay until 1985 postpones resolution of the problem until mid-1985 at the earliest. This would push collection of any new taxes and spending restraints into 1986. Such a delay could very well be too late and will continue to perpetuate uncertainty during the period of the delay. The deficit time bomb is indeed ticking, and the clock is approaching midnight.

We are now almost six months into FY'84. Fiscal year 1985, the crucial year, will begin in October, 1984. This timing necessitates action immediately if out-year deficits are to be sent on a downward trend.

As to the specifics needed to bring the deficit down, NAHB urges the Congress to adopt the operating premise that spending cuts and tax increases should be as broad based as possible. They should be fair in the sense of broadly affecting all income levels and sectors of the economy. On the revenue side, they should strive toward investment neutrality -- i.e., not shift the relative attractiveness of capital from one economic sector to another thereby altering the present mix of investment options.

NAHB has endorsed the Danforth-Boren, Jones-Campbell "de-indexing" proposals. NAHB also endorsed the general elements of the Finance Committee deficit-reduction package of 1983 which includes an energy consumption tax, a surtax on high income individuals, and a corporate surtax.

On the spending side, concepts such as reducing the non means-tested cost of living adjustments (COLAs) has a great deal of merit. Revisions, such as a delay of three to six months of COLA increases, should be considered. If the Congress deems that it is not politically possible to revise the Social Security program, they should turn to other entitlement programs, particularly Medicare. The spending cuts should be made concurrently with tax increases to prevent taxes from being increased without commensurate spending reductions.

Another area of spending which needs to be examined is the overall domestic discretionary budget and the defense budget. As former President Gerald Ford stated during a debate on the deficit before our recent annual Home Builders convention in Houston, there exists no reason why four year defense contracts cannot be stretched to five years as a means of addressing the deficit. He believes rather fervently that such action would not place our national defense at risk. Since it remains no secret as to President Ford's position on defense issues, such a proposal for moderating these defense expenditures deserves careful consideration.

In the area of tax increases, a great deal of discussion has been directed toward major restructuring of the tax code. Consumption taxes, a value-added tax, or alternatively, a major broadening of the income tax base have been looked upon as likely new sources of revenue. NAHB urges that the Congress delay consideration of major structural changes until 1985. What is needed at present is modification of the current law in as broad based a manner as possible to raise the revenues needed to reduce the federal deficit. The implications of major restructuring remain unclear and such changes should be the result of extensive debate and consideration.

In seeking to develop a tax package for 1984, NAHB urges the Congress to avoid changes which are designed to raise revenues through relatively minor changes affecting various sectors of the economy. This approach, which was employed in 1982, could, instead of raising revenues, jeopardize the incentives for economic growth which are a part of the tax code. Tax increases directly affecting real estate would increase the current investment bias established in 1981 against investment in housing as opposed to other investment and savings alternatives. We should continue to provide incentives to save in order to strengthen the capital base necessary for investment which is vital for sustained economic growth.

For individuals, proposals to cap the mortgage interest deduction or other tax benefits for housing would have a devestating effect on the housing market. On the business side, tax increases affecting real estate would accentuate current biases against business investment in real estate. One measure which has received attention is a lengthening to 20 years of the depreciation period on structures. Currently, structures have a depreciation period that is three times longer than equipment. To increase the disparity to four times would be highly detrimental -- pushing capital away from high risk investment in residential rental projects.

Finally, part of the Finance Committee deficit reduction measures and the Administration's budget are directed towards "tax shelters." These changes should be viewed with caution. For real estate investment, so-called tax shelters are a legitimate and necessary means of attracting needed capital. The changes that have been outlined could very drastically affect capital formation, making it difficult to attract needed investment capital. NAHB shares the concerns of the Department of Treasury and Congress over tax evasion techniques. We support proposals to close unintended "loopholes" and to improve compliance while preserving legitimate approaches for encouraging capital formation.

In summary, we realize Congress and the Administration cannot eradicate budget deficits overnight. We also agree that the economy continues to improve and our own forecasts for housing construction for 1984 look very favorable. However, we know better than most major industries the impact of interest rates on sustained long-term growth. Having undergone the most severe recession since World War II we are now leading the recovery, but, unless and until the deficits are dealt with by Congress and the Administration this recovery cannot last. The ticking "time bomb" is real.

Again, we look forward to working with you in any way you believe will be productive.

ECONOMIC IMPACT OF RESIDENTIAL CONSTRUCTION

The construction of 1,000 single family units generates an estimated 1,759 man years of employment and more than $32,500,000 in wages. The total economic impact of these units (employing a multiplier of 2) is $146,900,000, while the total tax impact is $14,700,000.

The corresponding figures for 1,000 multifamily units are 826 man years of employment, $15,200,000 in wages, $67,200,000 in total economic impact, and $7,200,000 in total tax impact.

	Employment Impact of 1,000 New Single Family Units		Employment Impact of 1,000 New Multifamily Units	
	Man Years	Wages	Man Years	Wages
All Industries	1,759	$32,540,000	826	$15,170,000
Construction	627	13,600,000	318	6,900,000
On Site	525	11,440,000	273	5,950,000
Off Site	102	2,160,000	45	950,000
Other Industries	897	13,960,000	443	6,890,000
Manufacturing	397	6,430,000	240	3,890,000
Wholesale Trade, Transportation and Services	355	4,610,000	153	1,990,000
Mining and All Others	145	2,920,000	50	1,010,000
Land Development	235	4,980,000	65	1,380,000

	Tax Impact of 1,000 New Single Family Units	Tax Impact of 1,000 New Multifamily Units
Total Tax Impact, All Levels	$14,718,000	$7,188,000
Total Federal Taxes	12,658,000	6,028,000
Federal Personal Income Tax	4,090,000	1,890,000
Federal Corporate Income Tax	4,240,000	2,120,000
Builders	3,230,000	1,540,000
Suppliers	1,010,000	580,000
Social Security Tax	4,328,000	2,018,000
State Personal Income Tax	550,000	260,000
Local Real Estate Tax	1,510,000	900,000

	Total Economic Impact of 1,000 New Single Family Units	Total Economic Impact of 1,000 New Multifamily Units
Value Per Unit	$ 83,000	$ 40,000
Total Economic Impact	$146,910,000	$67,200,000

Source: NAHB Economics Division

AFFORDABILITY OF HOUSING

(Based on a 30-year term, $60,000 fixed-rate mortgage)

Interest Rate	Monthly Prin/Int Payment	Total Monthly Expenses*	Annual Income Needed to Afford	Number of Families w/ Income Needed	Percent of Families w/ Income Needed
		Assumes Expenses Equal One-Fourth of Income			
8%	$ 440	$ 655	$ 31,440	17,820,000	29.7%
9%	483	698	33,504	15,180,000	25.3%
10%	527	742	35,616	12,960,000	21.6%
11%	571	786	37,728	11,760,000	19.6%
12%	617	832	39,936	10,560,000	17.6%
13%	664	879	42,192	9,240,000	15.4%
14%	711	926	44,448	7,980,000	13.3%
15%	759	974	46,752	6,720,000	11.2%
16%	807	1,022	49,056	5,400,000	9.0%
17%	855	1,070	51,360	less (4,860,000	less (8.1%
18%	904	1,119	53,712	than (	than (
		Assumes Espenses Equal One-Third of Income			
8%	$ 440	$ 655	$ 23,580	28,140,000	46.9%
9%	483	698	25,128	25,740,000	42.9%
10%	527	742	26,712	23,760,000	39.6%
11%	571	786	28,296	21,780,000	36.3%
12%	617	832	29,952	19,680,000	32.8%
13%	664	879	31,644	17,520,000	29.2%
14%	711	926	33,336	15,420,000	25.7%
15%	759	974	35,064	13,260,000	22.1%
16%	807	1,022	36,792	12,300,000	20.5%
17%	855	1,070	38,520	11,340,000	18.9%
18%	904	1,119	40,284	10,320,000	17.2%

These figures are based on current estimate of 60,000,000 families in the United States, and a 1981 family income distribution estimated by the NAHB Economics Division is applied.

* Includes taxes, insurance maintenance and repairs, heat and utilities.

Source: NAHB Economics Division

Chairman **Domenici**. Dr. Carlson, I wanted to give you a chance to correct the record. A while ago you were looking this way, and you complimented the members who were present. At that point, you did not look that way, and there were two present. Did you intend to include those two Senators also?

Dr. **Carlson**. Sir, I just remember specific actions taken by certain Senators, and I am sure there were others that I missed, and I apologize.

Chairman **Domenici**. John Motley is director of Federal legislation for the National Federation of Independent Business.

STATEMENT OF JOHN J. MOTLEY III, DIRECTOR OF FEDERAL LEGISLATION, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. **Motley**. Thank you Mr. Chairman and members of the committee.

On behalf of NFIB and its 570,000-member firms across the country, I thank you for this opportunity to appear here today and to discuss the administration's fiscal year 1985 budget proposal.

I have a prepared statement which I would like to submit for the record and then to summarize for you, if I can.

Chairman **Domenici**. It will be made a part of the record, without objection.[1]

STATE OF SMALL BUSINESS ECONOMY

Mr. **Motley**. If I can digress for just a second before getting into the budget itself, I would like to share with you the results of NFIB's most recent Quarterly Economic Report on Small Business, which deals with the fourth quarter of 1983, and which will be published very shortly. In effect, this says that 1983 is probably the best year that the small business community of this country has had since 1978.

Inventories are up. Sales are up. Profits are up. All of the leading indicators for the small business community except capital investment are up. Optimism within our membership is at an all time high. Hiring according to the last quarterly, or the expectations for hiring during the first quarter of this year are 18 percent of the firms answering the quarterly expect to hire at least one new employee. That is a record for the quarterly, which is now in its 10th year. Only 7 percent of those firms answering intend to let go employees, for a net of 11 percent of the total that would be looking to increase hiring during the first quarter of 1984. Again, this would be a record for the NFIB quarterly economic report.

CAPITAL INVESTMENT WEAK

As I said before, capital investment is still very weak, but it is increasing also, although much more slowly than we would like to see. Borrowing is definitely down. The reason for that is probably that real interest rates remain high and that small firms are paying somewhere between 2 to 2.5 percent above prime for their money.

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[1] See p. 350.

Chairman DOMENICI. Is capital investment down relatively speaking?

Mr. MOTLEY. I believe capital investment is down relatively speaking, Senator.

Chairman DOMENICI. But it is up, but not up as much as the others?

Mr. MOTLEY. It is not up as much as the others. That is true.

Also, I think you have to remember here the nature of smaller firms. Many of them are much more labor intensive than they are capital intensive. They really cut themselves back to the bare bone during the recession. The first thing that is happening as they come back is hiring the employees that they let go. Employees are generally much more essential to them than capital investment, or at least in the mix of the type of firms that we represent.

MOST ADVANCES MADE WITH CASH

Two other points should be noted. Most of these advances have been made with cash rather than by going to the bank and borrowing on a regular basis. We see two reasons for this.

No. 1, these firms are again very lean in comparison to where they were before they went into the recession. Therefore, their profitability is much higher, and they have an awful lot of cash on hand.

In addition to that, we finally believe that the 1981 tax cuts are beginning to come into play, also improving the cash position of our membership.

With that, let me switch to the President's 1985 budget proposal.

Chairman DOMENICI. Before you do that, let us do this. Senator Biden has just been called to the floor. They are going to a bill which he has to manage on the minority side. He would like to make an observation, and then you may continue.

Senator BIDEN. I apologize for interrupting. I would like to ask permission or unanimous consent, Mr. Chairman, that several questions I have be submitted in writing. One of them relates to a constitutional amendment for a balanced budget and what your views on that are.

I apologize but I must go to the floor and manage this bill.

Chairman DOMENICI. Would you answer those within a week?

Mr. MOTLEY. Certainly.

Chairman DOMENICI. Thank you very much. Your response will be made a part of the record.[1]

Please proceed.

POSITION OF SMALL BUSINESS

Mr. MOTLEY. Senators, I do not think that there is any doubt that the traditional position of the small business, the Main Street business community of this country, is that deficits are bad. They do not believe in them. They do not like them. They do not believe that the Government should run them.

They believe the Government should be run as close to a business as possible, and it should not be overextended. An overextended business is in trouble, and many of them learn that lesson very, very severely, as they did during the recent recession.

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[1] See p. 664.

They also believe that there is a relationship between interest rates and the deficit. They are terribly concerned, especially about the future. In that particular position, they would agree with the particular industry representatives that have testified here before. I think the feeling is shared, it is unanimous.

DEFICIT TOO HIGH

The $180 billion deficit that is contained or projected by the President's 1985 proposal is certainly way too high and very unacceptable to our membership. They believe that the consistently high deficits that are forecast for the future are even going to be a bigger problem than the immediate problem of 1985.

While small business people agree about the problem, it is somewhat unusual that they also tend to agree about the solution. And that is that you should not increase taxes, you cut spending.

CUT SPENDING FIRST

Realizing that this scenario would be a political problem for the Congress, we in NFIB have proposed 11 times over the last 2 years, from increasing excise taxes to reducing or repealing indexing, various different tax increase proposals to our membership. And all 11 times, they have voted against increasing taxes. All but two, and that would be increasing excise taxes and the CPI minus three proposal that was mentioned by Dr. Carlson, have been by more than two-thirds majorities voting against additional tax increases. These are votes of roughly 60,000 to 90,000 NFIB members each time during that period.

So, there is definitely a consensus within our membership that, if the deficit is to be reduced, it should be reduced first through cutting spending and not through increasing taxes.

I think they see the problem as being rather simple. And I am not too sure that they are aware of this but, if they knew the figures, they would probably put it to you this way. Revenues are pretty close to their historical norm in this country, somewhere around 19 percent. They are a little below that now, but they are close to their historic norm. Expenditures, on the other hand, are three to four points, maybe even as much as five points above their historic norm. The difference you have between those two figures is your current deficit, and they believe that the only way to address that is to reduce spending.

SUGGESTIONS ON HOW TO REDUCE SPENDING

As far as suggestions as to how you go about doing this 'they would certainly agree with some of the things that were mentioned by Dr. Carlson and by Mr. Herder. We support a constitutional amendment to balance the budget. We also support line-item veto authority for the President of the United States.

We would support something similar to the suggestions made by Senator Hollings of this committee. That would be an across-the-board freeze on Federal expenditures and also tax reductions. A freeze which had a definite period of time, one or two years, we think, would be very equitable and something that everybody could live with.

If you wanted to go beyond that, we would support an across-the-board cut in expenditures, although I doubt very seriously that the Congress would be willing to pass that.

We have additional suggestions. We have been looking at, over the last couple of years, the whole issue of contracting out, the commercial activities that the Federal Government should or should not be in. We believe that there is ample evidence for this committee to look at: a 1981 Government Accounting Office study; a 1982 Small Business Administration study; and more recent studies by the Department of Defense, indicating significant savings can be achieved by contracting out certain services to the private sector.

We would also urge you to take a close look at certain elements of the Grace Commission report. NFIB did play a role in the Financial Assets Management portion of that report. Several of our board members participated in it. It is the only section of the report that we would feel comfortable in recommending to you in its entirety. But we do believe that Congress should take a very close look at all aspects of that report and, wherever applicable, should use it to reduce Federal spending.

Looking at it from the standpoint of staff, I have always found it rather amazing that Congress or any administration has always tried ways to reduce spending; yet, there are programs out there that the constituencies for those particular programs say they do not necessarily need. I use an example in our own backyard here, and that is the Small Business Administration. There are programs which have developed rather small political constituencies over at that administration which have existed for years and continue to exist, even though most of the organized small business community says that they are not needed. And I will be glad to provide examples for the committee if they would so like to have them.

TAX REFORM

One last point is the area of tax reform, a very popular topic. I guess we think if we reform the tax code of the country, we can automatically come up with the amount of revenue that we need to balance the budget. I do not think it is quite that easy.

One of the more popular proposals that is out there right now is the Bradley-Gephardt fair tax proposal. It is very intriguing, and in concept NFIB members support changes in that direction. There is no doubt about it. But I would pose to you that there would be a very significant problem for the small business sector. Small corporations now are roughly paying—well, let us say 72 percent of all small corporations in this country right now are paying 15 percent in corporate taxes. Under Bradley-Gephardt, that would go up to 30 percent, a very significant increase in taxes for the very smallest corporations in the country. And I do not think that would be very popular back home.

That concludes my remarks, Mr. Chairman. I would be delighted to try and answer any questions that the committee might have. Thank you very much.

Chairman DOMENICI. Thank you.

[The prepared statement of Mr. Motley follows:]

NFIB® National Federation
of Independent Business
The Guardian of Small Business

STATEMENT OF

JOHN J. MOTLEY III
DIRECTOR OF FEDERAL LEGISLATION

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Before:	Senate Budget Committee
Subject:	1985 Budget
Date:	February 7, 1984

My name is John J. Motley III, Director of Federal Legislation for the National Federation of Independent Business (NFIB). On behalf of the more than 560,000 members of the NFIB, I am here to discuss the small business perspective on the Administration's FY 1985 budget proposal, and its impact on small business.

Each year's Federal budget proposal is controversial. However, no budget proposal of a President has ever consisted of so many individual elements which will likely result in such widespread controversy. This proposal is a result of our continued attempt to mortgage the future for the present. Our duty is to start paying off the mortgage with not just a down payment, but with a program of serious monthly payments.

State of Small Business Economy

Nineteen hundred eighty-three will reveal itself as the best year small business owners have had in some time. The NFIB Quarterly Economic Report for Small Business (QER) for the third quarter of 1983 revealed very strong results, and high expectations abounded among small business owners for the fourth quarter. Small firms as a group will likely complete the year with their best 12-month performance since 1978.

Expectations among small business owners was for a strong fourth quarter performance, with the added benefit of increasing plans to make capital expenditures. The overriding concern of small business owners continued to be high interest rates and the specter of increasing rates in the near future, which may help explain the QER's finding that the percentage of firms borrowing during the third quarter was near record lows, providing many small firms a well-earned respite from high credit costs. Improved sales and profits, combined with lower taxes, encouraged firms to do much more internal financing than in the past, further reducing borrowing requirements.

Those firms which continued to borrow paid an average of 2.5% over prime for funds. Interest rates averaged 13-15% among small borrowers, and expectations among small business owners for reductions in interest rates were not high.

The specter of increasing interest rates resulted in 23% of the membership expressing concerns that the next few months will be a poor time for small business to undertake plans for expansion. The recent surge in inventory accumulation was clearly undertaken despite high real interest rates. Further, the low percentage of borrowers and the lack of capital expenditures in the recovery to date suggest interest rates could provide counterproductive to sustained strong economic growth.

Another casualty of higher interest rates may be the increasingly positive employment picture for small business. If expansion and inventory accumulation plans are postponed or cancelled due to higher borrowing costs, then the economy loses the major driving force for reduced unemployment and any resulting budgetary benefits.

The critical role small business plays in the prospect of a continued and vigorous economic recovery and reduced unemployment was illustrated in a recent article by Peter F. Drucker in the January, 1984, Harvard Business Review, entitled "Our Entrepreneurial Economy." Between 1979 and 1980, small and new businesses provided the bulk of the 20 million new jobs created. During this same time period, the Fortune 500 companies lost a net 3 million jobs. More surprisingly, the bulk of the new jobs created were in either low-tech or no-tech businesses. Traditional retail, services, wholesale, and manufacturing lines were the stars in small- and medium-size firms. Increasing interest rates may not only stop new employment but reverse the trend of employment growth in small business which has lasted for well over 10 years.

The QER optimism index reveals that small business owners view our economy as being basically healthy and having tremendous potential for continued growth. However, a large increase in interest rates has the potential for reversing all of the benefits which we have reaped from a healthy economy. Decisions and choices on the 1985 budget must be viewed in the context of reducing interest rates while fostering continued growth in production.

FY 1985 Budget Overview

The Administration's budget proposal for FY 1985 provides for outlays of $925 billion and revenues of $745 billion, leaving a projected deficit of $180 billion in FY 1985. It is estimated that at the end of FY 1985, the gross Federal debt may be $1.828 trillion. This will represent 47% of projected gross national product for that year.1/

As alarming as gross numbers appear, several budgetary trends in the outlays and receipts area are exhibiting positive results.

1/ FY 1985 Budget of the U.S., Table 25.

Table 1-1 from the Economic Report of the President reveals that in FY 1983, total outlays as a percent of GNP peaked at 24.7%. In FY 1985, it is estimated that outlays will fall to 24.3% of GNP, and by 1989, to 23% of GNP. Contrary to this trend, however, are outlays for national defense, net interest, social security and medicare, all of which are projected to increase through the decade. These items fall into an area of the budget entitled "Relatively Uncontrollable Outlays."

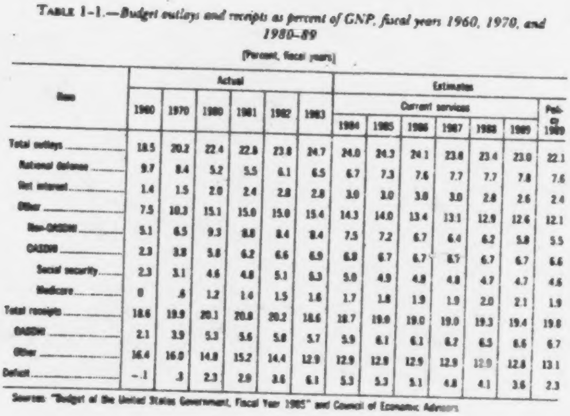

TABLE 1-1.—*Budget outlays and receipts as percent of GNP, fiscal years 1960, 1970, and 1980–89*

[Percent, fiscal years]

Item	Actual						Estimates						
							Current services						Policy 1989
	1960	1970	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	
Total outlays	18.5	20.2	22.4	22.8	23.8	24.7	24.0	24.3	24.1	23.8	23.4	23.0	22.1
National defense	9.7	8.4	5.2	5.5	6.1	6.5	6.7	7.3	7.6	7.7	7.7	7.8	7.6
Net interest	1.4	1.5	2.0	2.4	2.8	2.8	3.0	3.0	3.0	3.0	2.8	2.6	2.4
Other	7.5	10.3	15.1	15.0	15.0	15.4	14.3	14.0	13.4	13.1	12.9	12.6	12.1
Non-OASDHI	5.1	6.5	9.3	8.8	8.4	8.4	7.5	7.2	6.7	6.4	6.2	5.8	5.5
OASDHI	2.3	3.8	5.8	6.2	6.6	6.9	6.8	6.7	6.7	6.7	6.7	6.7	6.6
Social security	2.3	3.1	4.6	4.8	5.1	5.3	5.0	4.9	4.8	4.8	4.7	4.7	4.6
Medicare	0	.6	1.2	1.4	1.5	1.6	1.7	1.8	1.9	1.9	2.0	2.1	1.9
Total receipts	18.6	19.9	20.1	20.8	20.2	18.6	18.7	19.0	19.0	19.0	19.3	19.4	19.8
OASDHI	2.1	3.9	5.3	5.6	5.8	5.7	5.9	6.1	6.1	6.2	6.5	6.6	6.7
Other	16.4	16.0	14.8	15.2	14.4	12.9	12.9	12.8	12.9	12.9	12.9	12.8	13.1
Deficit	−.1	.3	2.3	2.9	3.6	6.1	5.3	5.3	5.1	4.8	4.1	3.6	2.3

Sources: "Budget of the United States Government, Fiscal Year 1985" and Council of Economic Advisers.

Table 20 in the budget proposal states that, of a total of $925.5 billion, $688.4 billion, or 74.4%, of the total budget is untouchable or uncontrollable in these budget deliberations. While politically this may be a prudent decision, negotiating budget cuts simply on the basis of cutting defense and a small amount of civilian programs (which comprises the remaining 25%), leaves a very lean starting point from which to reach compromises on spending reductions.

Receipts as a percentage of total GNP dropped to 18.6 percent of GNP in FY 1983. However, budget receipts start increasing in FY 1983 and will do so through FY 1989. The increase in receipts is partly due to increased tax revenues which are a result of greater business profits. However, the increase in tax receipts also stem from higher social security taxes and other tax increases legislated in 1982.

NET EFFECT ON RECEIPTS OF ENACTED LEGISLATION [1]

(In billions of dollars)

	1983	1984	1985	1986	1987	1983-1987
Economic Recovery Tax Act of 1981	−91.1	−133.6	−165.0	−207.7	−248.5	−845.9
Tax Equity and Fiscal Responsibility Act of 1982	16.6	35.4	39.7	49.3	60.7	201.8
Highway Revenue Act of 1982	1.5	4.1	4.2	4.4	4.5	18.7
Social Security Amendments of 1983		6.2	8.8	9.3	11.4	35.8
Interest and Dividends Tax Compliance Act of 1983	−0.1	−2.6	−2.4	−2.1	−1.7	−8.8
Railroad Retirement Revenue Act of 1983	*	0.2	0.7	1.1	1.1	3.1
Net tax reduction	−73.0	−90.3	−113.8	−145.7	−172.6	−595.4

*$50 million or less.

[1] These estimates are based on the direct effect only of legislative changes at a given level of economic activity. Induced effects are taken into account for forecasting incomes, however, and in this way affect the receipts estimates by major source and in total.

This table illustrates that tax legislation passed subsequent to the Economic Recovery Tax Act of 1981 reversed a substantial amount of tax benefits received by business and individuals in 1981. As a result of these subsequent tax increases, tax relief was reduced 20% in FY 1983, 32% in FY 1984, and 31% in FY 1985--not insignificant amounts of revenue, as many would have you believe.

In particular, Social Insurance Tax and Contributions will increase by an estimated 55% over the period of FY 1983 to FY 1987. In FY 1987, projections are that 36.5% of all revenue sources will be from social insurance taxes. Historically this continues a trend which may prove to be the worst type of social planning ever devised, as the tax on labor used to fund social security becomes so high that it actually inhibits the level of employment and the ability of the government to pay benefits.

General trends in the Federal deficit definitely are not encouraging. For FY 1985, the projected budget deficit will be 4.6% of GNP, lower than the record of 6.1 percent set in FY 1983 but significantly high historically.

While many will debate the budgetary effect of the deficit on the current recovery in terms of the deficit's potential harm on interest rates and inflation, it is in the long term that deficits will prove to be most harmful to all concerned. If projections are accurate and by 1989 the Federal debt equals 50% of GNP, the damage to the economy may become so severe that drastic and dramatic action may be required.

Budget Proposals

A. Taxes

For FY 1985, the deficit is projected at $180 billion. The cumulative long run effects of continuing high deficits are severely damaging to the general economic base, as the government is forced to borrow an ever increasing amount, thereby forcing public and private borrowing to collide. However, the cure for high budget deficits is not simply to raise taxes to 24 percent of GNP. So heavy a tax burden would drastically curtail the ability of many small business owners to survive, causing further revenue erosion and recession which exacerbates deficits through greater federal spending.

Consistently, NFIB members have expressed their strong desire to see the deficit reduced. Just as strong is their conviction that the budget should not be balanced through increasing taxes. Nor are they enamored with any of the elaborate schemes concocted which attempt to trade some spending reductions for some tax increases. Flatly, NFIB members believe that Congress and the Administration must address the spending side of the budget problem.

The Administration's budget proposal contains proposals for $33.5 billion in net new Federal revenues within 25 various proposals. While some of these initiatives have been supported by NFIB members and some are not, raising revenues is not where small business wants the deficit debate to begin. The spending side must be addressed before tax increases should be considered.

B. Spending Restraint Proposals

While each individual member of NFIB may have a particular section of the budget which he or she would eliminate, clearly the decision over which budget areas are funded resides in Congress. But, ask a business owner how to deal with the deficit and his answer is, cut across the board in all categories. Reduce spending by whatever percentage is required, in all areas of your budget, to allow the continued survival of the firm, or in this case the government.

To some this approach may appear simplistic, to some unfair, but as neither Congress nor the Administration appear to have the desire to recommend any specific reduction in any programs due to political sensitivities, just request all agencies to implement an X% reduction in programs. With proper management, the dollars and the reductions can be found.

This kind of action is necessary to precipitate even more drastic action that might be deemed necessary if the economy does not perform as predicted. This point is illustrated by a table in the budget which illustrates the effect on the deficit of a shift in the composition of nominal GNP. The differences in deficit projections, if one assumes high growth and low inflation or low growth and high inflation, grows to a difference of $140 billion by 1989.

SENSITIVITY OF THE BUDGET TO RATES OF ECONOMIC CHANGE

(Fiscal years, in billions of dollars, current law basis)

	1985	1986	1987	1988	1989
Effect of a one percentage point change in annual nominal GNP growth rate resulting from:					
A one percentage point higher annual rate of inflation (and interest rates) beginning January 1985:					
Receipts	3.7	13.4	23.9	37.0	51.4
Outlays	3.6	11.4	18.3	25.0	30.3
Change in deficit	−0.1	−2.0	−5.6	−12.0	−21.1
A one percentage point lower annual rate of real growth beginning January 1985:					
Receipts	−3.2	−12.9	−24.5	−38.5	−54.1
Outlays	1.0	3.7	7.3	11.4	16.2
Change in deficit	4.2	16.6	31.8	49.9	70.3

EFFECT ON DEFICIT OF SHIFT IN THE COMPOSITION OF NOMINAL GNP

(Fiscal years, in billions of dollars)

	1985	1986	1987	1988	1989
Administration forecast of total deficits	−195.2	−185.9	−187.7	−159.7	−128.2
Alternative deficit projections: [1]					
Higher growth/lower inflation	−191.6	−172.2	−162.2	−122.0	−73.5
Lower growth/higher inflation	−197.4	−198.5	−218.5	−216.5	−213.9

[1] Alternative projections assume that the rates of growth of real GNP and inflation are changed in opposite directions and by 1 percentage point beginning in January 1985. Interest rates are assumed to be 1 percentage point lower than in the administration forecast in the first alternative, but not to change after 1984 in the second.

A change in inflation rates by one percent or a change in the annual growth rate of one percent results in a substantial difference in budgetary numbers and resulting deficits. While it is comforting to see forecasts of consistent levels of growth and inflation, we all realize that the unexpected will happen, and unexpected events can wreak havoc with the best of forecasts. So while it is true that economic factors may actually be better than predicted, some may also be worst. With the national debt approaching 50% of GNP, we need to err on the side of conservative economic projections and cut spending and the resulting deficits.

C. Other Cost Reduction Proposals

NFIB members have endorsed several specific budget reduction proposals which are really management reforms, which you may wish to consider as well.

CONTRACTING OUT

Significant savings can be realized through contracting out various functions which are performed by firms in the private sector.

A study by the General Accounting Office (GAO) indicates that "an estimated 400,000 federal employees are currently operating over 11,000 commercial or industrial activities at an estimated cost approaching $19 billion annually."[2] In other words, nearly one of every four employees of the Executive Branch civilian work force is currently engaged in activities which are clearly not of a policy, decisionmaking, or managerial nature, in direct competition with employees performing essentially the same activities in the private, for-profit sector. Yet a significant proportion of these activities cannot even be justified on a cost savings basis, in accordance with the dictates of Circular A-76. The GAO study points our that cost comparisons recently competed by the Department of Defense (DOD) "snow that more than half of its commercial activities could be obtained more economically by contract."[3]

Recently Congress has heard a great deal about the President's Private Sector Study on Cost Control, or the Grace Commission Report. Of the 38 staff reports issued by the Grace Commission, we feel comfortable in recommending that you specifically review the report on Financial Assets Management, since several NFIB members participated in drafting this report. This report makes several practical recommendations on how the Federal government can reduce spending simply by improved cash management procedures. Many of the management recommendations in this report are basic to many business owners and are worthy of consideration by Congress and the agencies.

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[2] U.S. General Accounting Office, Civil Servants and Contract Employees: Who Should Do What for the Federal Government? FPCD-81-43 (Washington, DC: Comptroller General of the United States, June 19, 1982), p. 15.

[3] Ibid.

We would also like to commend Senator Armstrong for recommending to the Senate that all portions of the Grace Commission's study be reviewed and, where possible, that the cost savings recommended by each report are implemented or proposed as legislation.

Summary

Congress and the Administration must come to terms with its spending priorities, and they must cooperate in reducing the areas of federal spending. It is unrealistic to nave 74 percent of the budget exempt from any federal action. This perspective is unrealistic. The entire budget must be considered, and room for reduced spending must be found in all categories.

We have recommended several specific areas of the budget that can provide you with a starting point for spending reductions. Approving greater cost savings by encouraging Federal agencies to contract out for services and goods is one way, reviewing the recommendations on Financial Asset Management in the Grace Commission report may be another.

NFIB stands willing to provide whatever support you may require to achieve the goal of economic recovery, which is a national goal that must transcend politics.

IGNORE POLLS AND TACKLE DEFICIT PROBLEM

Chairman **Domenici**. We are going to get to Mr. Trowbridge in a minute. Mr. Motley, you keep referring to polls, yours or others. If you were sitting in our shoes, are things bad enough where you ought to forget about polls and do something?

Mr. **Motley**. Senator, do I give that advice to those who are running this year or to those who are not running this year?

Chairman **Domenici**. Both.

Mr. **Motley**. Both.

Chairman **Domenici**. You do not run for your job, do you? I would not want to put you on the spot.

Mr. **Motley**. No, I do not.

Chairman **Domenici**. Well then, why don't you give us your advice?

Mr. **Motley**. I think that I would probably ignore the polls. I think that you should. And tackle the deficit situation, especially begin to tackle the deficit situation now. I do think that I agree with everybody else at the table. I do not think that it can wait too much longer. The problem that I foresee is that you have got a political stalemate, and you may have to wait until November in order to break that stalemate.

Chairman **Domenici**. I understand. We are addressing the issue in that context, from the President and all of us. We have a political stalemate. But I just wondered if you were all talking very seriously about the nature of these problems, and in some respect you are referring to them as if they are traditional likes or dislikes of your membership, occasionally cavalierly, as if it is just their opinion. I assume you think it is more than that when they are worried about deficits. And I assume you think $200 billion deficits are more than some long-standing phobia. And that is why I asked the question. Is this a serious enough one to forget about what polls tell us, if you were in our shoes, and do something?

Mr. **Motley**. In my opinion, it would be, yes, sir.

Chairman **Domenici**. All right. Now, Mr. Trowbridge of the National Association of Manufacturers.

STATEMENT OF ALEXANDER B. TROWBRIDGE, PRESIDENT, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. **Trowbridge**. Thank you, Mr. Chairman and members of the committee. I am equally grateful for this opportunity to meet with you on what is clearly the No. 1 economic policy dilemma facing this country and on which some, I think, bold and rapid action is called for.

I join those who hope that this working group, as proposed by the President, will be formed and will be about its business as rapidly and as constructively as possible.

On behalf of the roughly 13,500 member companies of NAM, I would like to make some comments on the President's proposed budget, beginning with three general observations.

MAJOR TAX INCREASES NOT APPROPRIATE

First, we are pleased that the President is proposing no major tax increases at this time. Of course, we do not necessarily agree with each of the so-called loophole closures being proposed in the budget. But, overall, we do agree with the President's position that major tax increases at this time, when some parts of the economy have yet to really come out of the recession, are not appropriate

CLOSE TAX LOOPHOLES

Senator **Metzenbaum**. Mr. Trowbridge, would you tell us which of the loopholes you would close.

One of the problems I have with the business community is they always think somebody else's ox should be gored, but I cannot get anybody to tell me when they are going to join our team and try to help us close some tax loopholes. So maybe you can help us.

Mr. **Trowbridge**. Well, sir, there are a number of them that have been discussed in the proposals, I think, before the Senate Finance Committee. One of those is the question of taxing of health insurance premiums.

It seems to us——

Senator **Metzenbaum**. That just hits the little guy again. And, you know, tell me about some of those that hit your people, like the oil companies and the banks and some of the special writeoffs that those fellows get when they have old properties and they sell one to the other and they just start to depreciate them on a 15 years basis.

Tell me some of those where you step on some toes of some of your buddies, not just some of my strong constituents.

TAX SYSTEM NO LONGER FAIR

Mr. **Trowbridge**. Senator, I think what you are really referring to is the very real and perceived feeling across the country that the tax system has become so complex and so filled with areas for manipulation that it is no longer fair and that we have the danger of people changing the traditional American belief that being a citizen means pay your taxes to a belief that you are kind of silly if you do pay taxes because there are lots of ways out of them.

My hope is that we can really seriously look at tax reform as proposed by the President and that a look this year would produce a simplified, fairer, more comprehensive tax alternative than the tremendous hodgepodge of items that are on the books now.

Senator **Metzenbaum**. I do not wish to interrupt your presentation, but what concerns me and what I try to say to my business friends and my wealthy friends is, you know, just tell me what I can do that you think we should do. I was with a fellow the other day, and he said, my business is selling tax shelters, but I think they are crazy. But when it comes to getting the establishment, people such as your trade association, that have a lot of political impact, I cannot get any of you to come up here and give us a real hand on some of the egregious cases that exist, banks having an artificial bad debt reserve, businesses making $1,900 million and paying no taxes.

That is not quite fair and it is not the American way. I am trying to get NAM, the U.S. Chamber, and NFIB and OAHB, or whatever—I do not know all your names—but all the business groups that exist out there—trying to get some of you to join our team and I do not mean my team. I mean Dole's team and I mean Rostenkowski's team and I mean Domenici's team and Chiles' team to see if you cannot really help us do something about this because the President is oblivious to the danger and we need your help. There are lots of places we could pick up money without raising taxes except on those who are getting a free ride.

Chairman Domenici. Why do you not proceed.

Senator Metzenbaum. I get so built up that I cannot contain myself.

Chairman Domenici. Would you like a cup of coffee? [Laughter.]

LARGER OVERALL REDUCTIONS IN FEDERAL SPENDING NEEDED

Mr. Trowbridge. My general observation is that in terms of its spending priorities, the administration's fiscal 1985 budget does not differ materially from its predecessor of last year, and on in the case of the 1984 budget the administration is again allocating the bulk of any real spending increases to the defense area while proposing only modest cuts in the growth of the nondefense portion of the Federal budget.

Our position is, we really need larger overall reductions in the growth rate of Federal spending, and furthermore, that such reductions must be distributed equitably across all portions of the budget, including the politically difficult and sensitive areas such as defense and entitlement spending.

A year ago we made the same observation regarding the 1984 budget and our view has not changed.

MAGNITUDE OF PROJECTED DEFICITS UNACCEPTABLE

A third general observation is likewise one we made at this time last year: Quite simply, we find that the magnitude of the deficits being projected through the end of this decade are just plain unacceptable. The administration projects an annual Federal deficit of about 5 percent of the gross national product for fiscal 1985, trending down toward perhaps 4 percent of GNP later in the decade.

The Congressional Budget Office, using somewhat less optimistic assumptions, has projected that the deficit will stay around 5 percent of GNP for the balance of the decade. Under either forecast, the national debt will double before the end of the decade. Deficits this enormous simply must be reduced.

Finding an acceptable way to do this has to be the first priority of this committee and the Congress, and perhaps a good way to begin is to place in perspective the size of the problem.

DANGER OF BECOMING ENURED TO DOLLAR DIMENSIONS

I was struck the other day by an article by Governors Lamm, Janklow, Matheson, and Snelling in the Washington Post on January 22, which said through repetition and familiarity we are in danger of becoming enured to the dimensions of the dollars we are dealing with.

How much is a billion, anyway? A billion seconds ago was 1951. A billion minutes ago Jesus Christ was walking the earth. A billion hours ago no one on this planet was walking erect on two feet. But in Washington a billion dollars ago was only 10.3 hours.

AREAS OF POTENTIAL DEFICIT PROBLEMS

It is obvious that this problem of the deficits does clearly matter. There is no way we can sweep this problem under the rug. Deficits of the size we are facing raise very potential problems in the following areas.

Inflation: large deficits will give rise to pressure for excessive money creation to finance the resulting increases in the national debt, and should this occur, renewed inflation will be the result.

Interest rates: large deficits, to the extent not financed through money creation, tend to crowd out the private sector in credit markets, leading to higher interest rates. And the expectation of renewed inflation resulting from the deficits is also a factor in keeping interest rates high.

Exchange rates: the current mix of relatively tight monetary policy and extremely loose fiscal policy is the single most important factor responsible for the overvaluation of the dollar. And this overvaluation has led to the deterioration in our trade competitiveness, manifested by both increased imports and decreased exports. Continued large deficits will further exacerbate this already serious problem by attracting additional inflows of foreign capital.

Debt service: continued high interest rates combined with the large deficits now being projected could create a self-perpetuating situation where an ever increasing portion of each annual deficit is attributable to rising debt service requirements, leading to almost complete loss of control over the national debt.

Moreover, future generations will have to reduce their standard of living to permit the Government to make payments on the national debt.

STRATEGY FOR LOWERING DEFICITS

It is unfortunately much easier to list the problems associated than it is to itemize the solutions. Our position is that the primary strategy for lowering deficits must be across-the-board reductions in the growth rate of Federal spending.

And in our view, no Federal activity should be immune from such treatment. This includes, as we have mentioned, defense and entitlement programs. Equally essential is curtailment of the growth in indexed entitlement spending. A meaningful first step toward adequate control of this part of the budget would be to reduce the annual indexing formula to substantially less than the increase in the consumer price index.

Such a step, difficult at any time, will be particularly hard in an election year, but something, we think, that must be done.

GOVERNMENT OUTLAYS SOURCE OF PROBLEM

We realize the political problems inherent in trying to control deficits exclusively through expenditure reductions. Nevertheless, we believe it is the proper solution because it reflects the actual source of the problem, which is Government outlays and not Government receipts.

Over the past decade, Government receipts have fairly consistently been in the range of 19 to 20 percent of GNP and, viewed in this perspective, the tax cuts enacted in 1981 did not really reduce the level of taxation, but rather will hold it at approximately the same range as before, about 19 or 20 percent of GNP.

The real problem is that Government outlays, which in the early seventies also were somewhere in the 19- to 20-percent range, now account for 24 or 25 percent of GNP. A spending increase of about 5 percent of GNP closely matches the size of the deficits, also projected at about 5 percent of GNP for the rest of the decade.

Excessive spending rather than inadequate taxation is the cause of the current deficit problem. Solutions should focus on reducing spending from this unprecedented high level and not on increasing taxes, which are at a normal level by historical standards.

While the foregoing represents our view, the optimum solution, we are not so naive as to ignore the possibility that Congress will try to reduce deficits by a package purporting to combine spending cuts with revenue increases. Our most recent experience with such a package, TEFRA, was not an unqualified success. Many feel that the TEFRA tax increases were not warranted by the spending cuts actually made.

Therefore, should something of the sort occur again, we strongly urge that any such package be structured so that on an annual basis no tax increase will go into effect until there has been an effective certification that planned spending cuts have already occurred.

MODIFICATIONS OF TAX SYSTEM ILL ADVISED

Finally, I would like to elaborate a little on why NAM believes that further modifications of the existing tax system are ill-advised. First, we think capital investment would probably suffer as a result of a major business tax increase. Throughout the seventies, businesses were excessively taxed as a result of two factors: the understatement of depreciation costs due to the inadequacies of the depreciation system then in effect; and the overstatement of inventory profits due to inflation.

While the Economic Recovery Act of 1981 attempted to provide a more realistic system of capital recovery allowances, the 1982 act cut back substantially on these important investment incentives, which should not be further eroded.

We also believe that any changes to the income tax enacted in the heat of an election year will be at best temporary expedients when what is needed is comprehensive reform. Congress should take the time necessary to address the deficiencies in the current tax laws on a systematic basis with a view toward producing a tax structure which is more efficient and more commensurate with stable economic growth.

Rather than rushing into piecemeal and ill-considered tax increases now, it may be more profitable for the Congress to take the time necessary to consider major reform or redirection of the tax system as part of any effort to achieve lower deficits.

SAVINGS VERSUS CONSUMPTION

In this respect, the major longrun problem of the American tax code has been its tendency to penalize savings and investment while subsidizing or otherwise rewarding consumption.

The treatment of savings versus consumption in the American tax system is highly atypical of tax codes throughout the industrial countries. Most of the major industrial countries derive a substantial share of their revenue from consumption taxes, most commonly through value-added taxes levied at the successive stages of production. The result is that, although the ratio of tax revenues to national income is lower in the United States than in all the major industrial countries except Japan, the share of revenue derived from income taxes in the United States is one of the highest in the industrial world.

Chairman DOMENICI. Mr. Trowbridge, we are going to have to ask you to take about 1 more minute.

Mr. TROWBRIDGE. Yes, sir.

Chairman DOMENICI. You have gone about 3 or 4 over. I did not want to hold you to Senator Metzenbaum's time.

Mr. TROWBRIDGE. I will wind it right up, sir.

We think that as part of this reform review, a really strong look at the consumption based tax should be included.

We do not endorse or recommend any specific type of consumption tax, but we do think Congress should carefully investigate the possibility of making major structural revisions in our tax laws, which would shift the incidence of taxation away from savings and investment in lieu of making further patchwork revisions to an already unwieldy income tax system.

That concludes my prepared remarks, Mr. Chairman. Thank you.

Chairman DOMENICI. Your statement will be made a part of the record.

[The prepared statement of Mr. Trowbridge follows:]

STATEMENT OF
ALEXANDER B. TROWBRIDGE
ON BEHALF OF THE
NATIONAL ASSOCIATION OF MANUFACTURERS
BEFORE THE
SENATE BUDGET COMMITTEE
ON THE ADMINISTRATION'S FY 1985 BUDGET
FEBRUARY 7, 1984

I am Alexander B. Trowbridge, President of the National Association of Manufacturers (NAM).

NAM is a voluntary business association of over 13,500 companies, large and small, located in every state. Eighty percent of these firms are considered to be small businesses. NAM member companies employ 85 percent of all workers in manufacturing and produce over 80 percent of the nation's manufactured goods. NAM is affiliated with an additional 158,000 businesses through its Associations Council and the National Industrial Council.

On behalf of our members, I am pleased to be here this afternoon to present our views on the Administration's proposed FY 1985 budget.

Let me begin by making three general observations about this budget. First, we are pleased that the President is proposing no major tax increases. Of course, we do not necessarily agree with each of the so-called "loophole closers" being proposed in the Administration's budget. But, overall, we strongly agree with the President's position that major tax increases at this time, when some parts of the economy have yet to really come out of the recession, are not appropriate.

Our second general observation is that, in terms of its spending priorities, the Administration's FY 1985 budget does not differ materially from its immediate predecessor. As in the case of its FY 1984 budget, the Administration is again allocating the bulk of all real spending increases to the defense area, while proposing only modest cuts in the growth of the non-defense portion of the federal budget. NAM's position is that we need larger overall reductions in the growth rate of federal spending and, furthermore, that such reductions must be distributed equitably across all portions of the federal budget, including politically difficult and sensitive areas such as defense and entitlement spending. A year ago, we made the same observation regarding the spending patterns in the Administration's FY 1984 budget, and our views have not changed.

Our third general observation is likewise one that we made at this time last year. This is, quite simply, that we find the magnitude of the deficits being projected through the end of this decade wholly unacceptable. The Administration projects the annual federal deficit at about 5% of the gross national product (GNP) for FY 1985, trending down towards about 4% of GNP later in the decade. The Congressional Budget Office (CBO), using somewhat less optimistic economic assumptions, has projected that the annual deficit will stay around 5% of GNP for the balance of the decade. Under either forecast, the national debt will double before the end of the decade. Deficits this enormous simply must be reduced, and finding an acceptable way to do this should be the first priority of this Committee. Perhaps a good way to begin is to place in perspective the size of the problem. As Governors Lamm, Janklow, Matheson and Snelling wrote in The Washington Post on January 22, 1984:

> "Through repetition and familiarity, we are in danger of becoming inured to the dimensions of the dollars we are dealing with. How much is a billion, anyway?
>
> "A billion seconds ago was 1951. A billion minutes ago Jesus Christ was walking the earth. A billion hours ago no one on this planet was walking erect on two feet. But in Washington, a billion dollars ago was only 10.3 hours."

You may conclude from the foregoing that at NAM we do believe deficits matter. Specifically, deficits of the size we are facing raise potential problems in the following areas:

-- Inflation. Large deficits will give rise to pressure for excessive money creation to finance the resulting increases in the national debt. Should this occur, renewed inflation will be the result.

-- Interest rates. Large deficits, to the extent not financed through money creation, tend to "crowd out" the private sector in credit markets, leading to higher interest rates. The expectation of renewed inflation resulting from the deficits is also a factor in keeping interest rates high.

-- Exchange Rates. The current mix of relatively tight monetary policy and extremely loose fiscal policy is the single most important factor responsible for the overvaluation of the dollar. This overvaluation has led to a deterioration in our trade competitiveness, manifested by both increased imports and decreased exports. Continued large deficits will further exacerbate this already serious problem by attracting additional inflows of foreign capital.

-- Debt Service. Continued high interest rates, combined with the large deficits now being projected (and which, if anything, may be understated) could create a

> self-perpetuating situation where an ever-increasing portion of each annual deficit is attributable to rising debt service requirements. This could lead to almost complete loss of control over the national debt. Moreover, future generations will have to reduce their standard of living to permit the government to make payments on the national debt.

It is unfortunately much easier to list the problems associated with the deficit than it is to itemize the solutions. NAM's position is that the primary strategy for lowering deficits must be across the board reductions in the growth rate of federal spending. In our view, no federal activity should be immune from such treatment. This includes defense and entitlements.

While national security can rightfully be called the highest priority of the federal government, this does not mean "no price is too high." We believe it likely that major economies can be achieved by combining a thorough review of our weapons programs with the achievement of more cost-efficient operations (for example, through implementation of the Grace Commission recommendations).

Equally essential is curtailment of the growth in indexed entitlement spending. A meaningful first step towards adequate control of this part of the federal budget would be to reduce the annual indexing formula to substantially less than the increase in the consumer price index (CPI). Such a step, difficult at any time, will be particularly so in an election year, but in our view it is something that must be done.

We realize the political problems inherent in trying to control deficits exclusively through expenditure reductions. Nevertheless, we believe it is the proper solution because it reflects the actual source of the problem, which is government outlays and not government receipts. Over the past decade, government receipts have fairly consistently been in the range of 19% to 20% of GNP. Viewed in this perspective, the "tax cuts" enacted in 1981 did not really reduce the level of taxation but rather will hold it at approximately the same range as before, about 19% to 20% of GNP. The real problem is that government outlays--which in the early 1970s also were about 19% to 20% of GNP--now account for 24% to 25% of GNP.

This spending increase of about 5% of GNP closely matches the size of the deficits, also projected at about 5% of GNP for the rest of the decade. Excessive spending rather than inadequate taxation is the cause of the current deficit problem, and the solution should focus on reducing spending from its unprecedented high level and not in increasing taxes, which are at a normal level by historical standards.

While the foregoing represents our view of the optimum solution, we are not so naive as to ignore the possibility that Congress will try to reduce deficits by a package purporting to combine spending cuts with revenue increases. Our most recent experience with such a package, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), was not an unqualified success. Many now feel that the TEFRA tax increases were not warranted by the spending cuts actually made. Therefore, should something of the sort occur again, we strongly urge that any such package be structured so that, on an annual basis, no tax increase will go into effect until there has been an objective certification that planned spending cuts have already occurred.

Finally, I would like to elaborate a little on why NAM believes further modifications to the existing tax system are ill-advised. First, we think capital investment would be likely to suffer as a result of a major business tax increase. Throughout the 1970s, businesses were excessively taxed as a result of two factors: the understatement of depreciation costs due to the inadequacies of the depreciation system then in effect, and the overstatement of inventory profits due to inflation. While the Economic Recovery Tax Act of 1981 (ERTA) attempted to provide a more realistic system of capital

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recovery allowances, the 1982 TEFRA tax increases cut back substantially on these important investment incentives, which should not further be eroded.

We also believe that any changes to the income tax enacted in the heat of an election year will at best be temporary expedients, when what is needed is comprehensive reform. Congress should take the time necessary to address deficiencies in the current tax laws on a systematic basis, with a view towards producing a tax structure that is more efficient and more commensurate with stable economic growth. Rather than rushing into piecemeal and ill-considered tax increases now, it may be more profitable for the Congress to take the time necessary to consider major reform or redirection of the tax system as part of any effort to achieve lower deficits.

In this respect, a major long run problem with the American tax code has been its tendency to penalize savings and investment while subsidizing or otherwise rewarding consumption. The treatment of savings versus consumption in the American tax system is highly atypical of tax codes throughout the industrial countries. Most of the major industrial countries derive a substantial share of their revenue from consumption taxes, most commonly through value-added taxes levied at the successive stages of production. The result is that although the ratio of tax revenues to national income is lower in the United States than in all of the major industrial countries except Japan, the share of revenue derived from direct income taxes (as opposed to indirect consumption-based taxes) in the United States is one of the highest in the industrial world.

The experience of the other industrial countries suggests that there are certain advantages to be gained by taxing consumption rather than income. Because the tax codes of other countries do not penalize investment to the same degree as the United States, these countries generally exhibit a higher level of personal savings and a higher ratio of capital formation to GNP. Increasing personal savings is important because it raises overall liquidity and permits the financing of government deficits without extensive upward pressure on interest rates. A higher level of capital formation, in turn, is necessary for higher productivity growth and improved international competitiveness. Taxation of consumption rather than income might also reduce the incentive for individuals to seek tax shelters.

NAM does not at this time endorse or recommend any particular type of consumption tax, but we do think Congress should carefully investigate the possibility of making major structural revisions in our tax laws which would shift the incidence of taxation away from savings and investment, in lieu of making further patchwork revisions to an already unwieldy income tax system.

This concludes my prepared remarks. I will be glad to address any questions members of the Committee may have.

Chairman DOMENICI. Now, we are going to try 5 minutes each. Anybody that wants to go a second round, I think the witnesses are going to be here. I am sure we can arrange that.

Senator Chiles, would you like to start?

HOUSING STARTS LAST YEAR LESS THAN AVERAGE

Senator CHILES. Thank you, Mr. Chairman.

Compared to 1982, 1983 was a boom year for housing. Residential starts were up 60 percent over the previous year but when compared to the past decade housing starts last year were less than average. Starts from 1970 through 1979 averaged about 1.8 million units annually. More were during the housing recovery of 1971 through 1973, and in both 1977 and 1978 starts were at least 2 million units per year, and certainly our population has grown substantially since then.

Given the performance of the housing industry during the decade of the seventies, how do you think this present recovery is measuring up?

Mr. Herder, do you want to start with that and then Dr. Carlson maybe?

HIGHEST DEMAND EVER FOR HOUSING

Mr. HERDER. We have a basic need in this country for 1.5 million units over the decade of the 1980's to meet the basic demand for housing. Historically, we have the highest demand in this decade from the baby boom where we have 42 million young Americans who are going to reach age 30 in this decade, the highest that we have ever had historically. So that begins to tell you that there is a great need for investment and for capital to meet the need for housing. This year we hit 1.7 million housing starts. We had 2 years where we were down around 1 million. So we still have not caught up with the basic need in this decade.

Senator CHILES. Dr. Carlson?

Dr. CARLSON. I would just add to that that given the pent-up demand and demographic demand, I would not expect the next 3 years to satisfy that. We should be around 2 million units and turning over about 4 million existing ones together with the remodeling and updating that goes with that. So we are falling quite short of what the demand is at normal interest rates.

However, at interest rates on mortgages, real interest rates, the interest rate above the inflation rate, the interest rate is more than double what we have seen in our history, and consequently you can see why people are not able to satisfy what the true demand is out there.

LOWER INTEREST RATES NEEDED TO MEET DEMAND

Senator **Chiles**. Well, let me ask you a followup question in two parts. One, do you think that housing starts during the first year of recovery, when they reach that 1.7, do you think that that has petered out? Is that the high water mark?

Do you think that housing starts could reach 2 million units during the current recovery?

Mr. **Herder**. Let me answer that this way: With the 12 percent to 13 percent interest rate that we have today, we really have skimmed off much of the affordable housing market, and that market at this same interest rate will not be there in 1984.

We are not going to meet the demand for the first-time home buyer who has a great need for affordable housing without lower interest rates.

Senator **Chiles**. You are saying even if we could keep the rate at 12 percent, it would not fulfill the number of units.

Mr. **Herder**. It would not meet the demand for affordable housing, especially for those young couples who need first-time housing.

Senator **Chiles**. Dr. Carlson, do you agree with that?

Dr. **Carlson**. Yes, sir. You can put it in the context of what we have experienced in the last 30 years. If the underlying inflation rate is around 5 percent, the average real interest rate on top of that inflation rate has been 3.75 percent during this 30 years.

So, the fixed rate mortgage should be around 8.75 percent or, say, 9 percent. Now, it is true we are asking people who borrow for homes to take more of the interest fluctuation risk; and we have adjustable rate mortgages. But even those are up around 11 percent. The fixed rates are 13 percent.

So, you can see, as was just said, the affordability factor, you cannot get down to the middle income person and to the below middle income person that we have historically done to bring them into home ownership; and they are continuing to rent.

Also, the——

Senator **Chiles**. To what level would the rates have drop to to get 1.7 million starts?

HOME OWNERSHIP RATE GOING DOWN

Dr. **Carlson**. Well, I would expect this year—I do not know what Pete's forecast is—about 1.75, about 1.7 million units, about as good as last year, maybe a little bit better. However, we are skimming off the folks that can afford that, not really keeping the American dream open to middle income and lower income America.

Consequently the home ownership rate has been going down since 1980, not because you meant to or the administration meant to, but we have had a series of antihousing policies that has reduced the ability for people to own their own home.

Mr. **Herder**. You see, what concerns us is there is still a lot of inflationary expectation built into interest rates relative to the deficit, and you also have the crowding out that is going to be experienced if the Government has to start borrowing what it needs to borrow in 1985 and 1986, and these two things together start to have the effect of keeping interest rates high.

PROJECTED HOUSING STARTS DIFFICULT TO REACH

Senator **Chiles**. In the President's budget submitted to Congress last week, the housing starts were projected to increase to 1.8 million units in 1984 and exceed 1.9 in 1985. It is my understanding most housing economists are predicting, as you said, between 1.6 and 1.8. I think you all are in that range for 1984, but for 1985 there appears to be a great deal of pessimism for continued growth in housing starts.

Do your projections coincide with the President's for 1985? Do you think that we can get 1.9 million starts with $200 billion deficits? Could we get to 2 million if we cut the deficits down?

Mr. **Herder**. Senator, I think with $200 billion deficits, we are going to have a difficult time reaching 1.8 or 2 million housing starts. Again, we have skimmed off a lot of that market. Only 10 to 15 percent of the young Americans today who have not bought a home can afford to buy one, and that is really a result of inflation, regulation, monetary and fiscal policy over the last 10 or 12 years.

There is a very slim market you get down to where only 10 or 15 percent of that age group can afford to buy a house.

Mr. **Carlson**. The key thing, that if you had a deficit reduction program, even if it was $30 billion cumulative adding on each year of reducing that deficit so it took you 5 to 6 years to get the structural deficit removed, when you pass that initially, within 90 days, you could get 1 to 1.5 percentage points off of the real interest rates, and consequently you would have a rather abrupt stimulus, not too abrupt, but you would have a significant stimulus to take care of investment everywhere, not just in housing alone.

Without that, I would expect that housing starts will be less in 1985 than they are in 1984 as we start going to slow growth and the next recession.

CURRENT LEVEL OF INTEREST RATES

Senator **Chiles**. In part, we know that mortgage rates are staying high because of the deregulation of the depository institutions, and that has increased competition for the loanable funds. I do not think that fully explains the unusual high cost of borrowing which currently exists.

How do you gentlemen explain the current level of interest rates? Given the relatively low rate of inflation and the fact that the rate that we have pretty well broken the back of inflation for now and the slackness in credit markets, what do you think the interest rate should be at this point in the recovery? I would like to go across the panel with that question. Mr. Trowbridge?

EXPECTATION OF UNCERTAINTY KEEPING RATES HIGH

Mr. **Trowbridge**. I believe, Senator, that the real prop underneath the abnormally high interest rates, high in terms of current inflation rates, is one of expectations. It is pegged to the problem we are dealing with here today, expected deficits; a feeling that we can, if current conditions continue, look forward to a return to inflation and subsequent crowding out possibilities. There is an expectation of uncertainty, which I think is as big a factor, a psychological factor as any economic factor involved.

There is plenty of liquidity at the moment in the system, and one would expect the liquidity to be reflected in lower rates for greater supply. That is not happening.

Senator CHILES. Mr. Motley.

Mr. MOTLEY. Senator, I would agree, I think, with everything that Mr. Trowbridge has to say. In addition, I would add to that, getting back to Senator Exon's point, I think there is a decided lack of confidence in the fact that the Government can set a course and then keep to that course.

There were an awful lot of people in this country who were hurt terribly during the seventies and they are being extremely cautious right now as far as investing their money and what they are getting in return for that money. It is the expectation that the Government will not be able to maintain a steady course in the future that is, in our estimation, keeping interest rates abnormally high.

Chairman DOMENICI. Could I ask a followup there?

Senator CHILES. Sure.

Chairman DOMENICI. With reference to the present situation, however, it would be that we are not going to be able to—that we are probably going to maintain a very steady course. Is that not right, namely a $180 billion deficit.

I mean, is that not the expectation?

Mr. MOTLEY. The expectation is that that course will be maintained and that the ultimate answer will be to monetize the debt again, and they are going to be caught short another time just like they were in the late seventies.

Senator CHILES. Mr. Herder?

Mr. HERDER. I think I pretty well covered that under inflationary expectation and crowding out. When you put those two factors together, we end up with interest rates at 12 percent and above. That does not do anything for housing nor anything for those young couples desperately in need of housing for the first time in record numbers in this decade. I think that is not only an economic problem, but a social policy that this country has to face.

The social implications of that related to communities and neighborhoods and home ownership, I think becomes a major issue.

IMPACT OF INFLATIONARY EXPECTATIONS ON CROWDING OUT

Senator CHILES. Well, we have expected crowding out. We are all afraid of that. I do not think crowding out is there right now.

Dr. CARLSON. No. Sir, on page 6 of my prepared statement [1] we tried to search the best way to measure what the impact of inflationary expectations in the future and future crowding out is. Our estimates show that over half of the current interest rate on mortgages is inflationary expectation. You are quite right; only about 10 percent of it is associated with current crowding out. It is the lenders' fear of being locked into a low-interest rate and then having interest rates go up, and thereby the purchasing power of that stream of interest payments is being eroded over time.

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[1] See p. 310.

I know of no better scholarship on this topic—and it has not been debunked, to the best of my knowledge—and the confidence intervals seem to be pretty good—suggest a high degree of significations. So I think that is our best estimate that we know of.

Chairman DOMENICI. Does that mean—did I do this right, that that is four for Feldstein and zero for the Secretary of the Treasury?

Dr. CARLSON. Yes, sir.

Chairman DOMENICI. So, four-zip.

Senator METZENBAUM. The White House is calling you, Pete. [Laughter.]

Chairman DOMENICI. No, the President is not in town. Go ahead.

POSITIONS DETERMINED BY MEMBERSHIP VOTE

Senator GORTON. Thank you, Mr. Chairman. First, Mr. Motley, I am going to have to apologize for the way in which the chairman went after the method by which NFIB came to its conclusions, primarily because I wanted to make that point.

But just so that we can understand this perfectly, of the four groups which are sitting before us right now, I believe I am correct in saying you represent the largest number of individual members. You do?

Dr. CARLSON. 627,000.

Senator GORTON. Where do you stand, Mr. Motley?

Mr. MOTLEY. I think, Senator, that we may represent the largest number of individual businesses, not individual members. And in order to be a member of NFIB, you have to own the business.

Senator GORTON. The positions which you have outlined for us here today are determined solely by a vote for which all of your members are eligible, is that not correct?

Mr. MOTLEY. Yes, Senator. That is the figure that I referred to, that most of those positions were determined by votes of between 60,000 and 90,000 members each time.

Senator GORTON. So you cannot come here and change your mind or on behalf of NFIB enter into some kind of an agreement without going back to those members.

Mr. MOTLEY. We definitely reflect the membership's opinion. Not only do we reflect it, but their vote binds us to a position.

Senator GORTON. Exactly. Have you gone back with any of these subjects to your members, especially subjects like proposals that we deal with the budget deficit by equal amounts of spending cuts and tax increases? Is that issue before your membership at the present time?

Mr. MOTLEY. Senator, I just happen to have the answer to that. In October of last year, in October-November of last year we asked the membership the CPI-3 question, and 58 percent of them voted against it, 35 percent in favor, and 7 percent undecided.

EQUAL SPENDING CUTS AND TAX INCREASES

Senator GORTON. Thank you. Now, understanding that you may be bound by this answer, I would like the comments of all four of you on one question; and I rather suspect that will take all of the time that I have here.

I want each of you to assume that as we approach this budget deficit problem in 1984 before a Presidential election that no substantial, successful attack on that problem can be mounted unless it involves some variant of the formula which I believe the first two people here spoke to: That is to say, roughly equal spending cuts and tax increases; that we either do it that way or we do not do it between now and the election.

Let us also assume, for Mr. Trowbridge particularly, that whatever agreement we reach of that nature is a real agreement, that it is not going to be one done with mirrors, but in fact over a 3-year period we would get an equal amount of spending cuts and tax increases.

I would like each of you to comment on would you favor such an attack on budget deficits, yes or no. Or is the position of your organization such that if it cannot be mostly spending cuts, you would just as soon see nothing at all.

If you do favor it, in theory, at what level do you favor it, the President's $100 billion over 3 years, Senator Dole's $150 billion over 3 years, or some larger figure than that?

Also if you are answering that last question in the affirmative, how positive an impact you would expect that kind of activity to have on lowering interest rates.

Chairman DOMENICI. You are right. That is going to take all your time. It will take all your time for next week, too.

CIP MINUS THREE PROGRAM SUPPORTED

Dr. CARLSON. The answer to the first one is yes, we have had a survey of our 627,000 members. They support the three for all program, the CPI minus three, both on the spending and tax side. There is a symmetry. Only 75 percent supported the indexing on the tax side, and over 90 percent in terms of the spending reductions.

We would support a known program that is going to occur over a number of years. We prefer six. We do not think shocks are desirable. We build by $30 billion a year to get the $180 billion over the 6 years and remove the structural deficit at that point.

We would expect in the first 120 days 1- to 1½-percentage point drop in real interest rates. We would expect a full effect of over 3-percent drop in interest rates. We have the scholarship in our testimony.

Senator GORTON. That is a full and complete answer, Mr. Chairman. It really is. I hope I get that from each of the other three.

THREE-PRONGED APPROACH TO REDUCING DEFICIT

Mr. HERDER. Dr. Carlson is an economist, and I am a homebuilder.

Our answer to the first one also is yes. We have had a three-pronged approach to it. First, we feel that there have to be cuts made in the entitlement programs. Second, there should be some moderation in defense spending over a period of time and as a last resort, if we have to, raise taxes but along with that corresponding decreases in spending.

Senator **GORTON**. How much over a 3-year period would you feel would be ideal? What effect would you expect it to have on interest rates?

Mr. **HERDER**. What we are talking about is $92.5 billion in fiscal year 1985. That is a start. I think the key to that is that it starts to show people that you are moving in that direction, and that is where this consumer confidence and confidence in the market comes back.

In housing there are two important elements: interest rates and consumer confidence. And that is related to what they see happening back here.

Chairman **DOMENICI**. Is that $92.5 billion equal, fifty-fifty?

Mr. **HERDER**. Yes.

Chairman **DOMENICI**. Half tax, half direct expenditure reduction?

Mr. **HERDER**. Yes, Senator.

Senator **METZENBAUM**. Did you mean $92.5 billion a year or——

Mr. **HERDER**. In fiscal year 1985.

Senator **METZENBAUM**. You said over a year.

Chairman **DOMENICI**. No, he said per year——

Mr. **HERDER**. It is $92.5 billion in the budget you are now considering.

Senator **METZENBAUM**. So, it would be $276 billion, $277.5 billion over a 3-year period. Is that what you are saying? Is that right? It is three times $92.5 billion——

Mr. **HERDER**. No. It is a down payment of $92.5 billion for fiscal year 1985. We have not projected budget reductions beyond fiscal 1985.

Senator **METZENBAUM**. OK. That is what I thought you meant, but I thought I heard you say $92.5 billion a year for 3 years.

Chairman **DOMENICI**. He did in his testimony say a year. No? OK.

Senator **GORTON**. Mr. Motley?

DO MORE ON SPENDING SIDE THAN TAX SIDE

Mr. **MOTLEY**. Senator, on the surface I would have to say that NFIB could not support such a move. Our membership obviously feels that more has to be done on the spending side than on the taxing side, although I would say that we would not dismiss any proposal out of hand. A great deal would depend on how that proposal was structured, especially on the tax side.

An example, an across-the-board surtax would give us a great deal of difficulty since we feel small firms already pay very high effective tax rates. Some large companies in this country do not pay very effective high tax rates.

So, we would definitely take a look at the structure, but on the surface I would say we would have a difficult time supporting a 1-for-1 attempt to reduce the deficit at this time.

As far as the level is concerned, if you assume that we could support it, I think that Congress could probably go a good deal higher than what they are looking at right now. I believe that the majority leader of the House was right in saying that you could double the amount of money that the President suggested could be found to reduce the deficit.

Senator **Gorton**. $200 billion

Mr. **Motley**. $200 billion over 3 years.

Of course, again, we would look to the majority of that coming on the spending side. There was a time when we supported, several years ago, a balanced budget within a period of 3 years. I do not think that that is terribly realistic any longer.

Senator **Gorton**. Mr. Trowbridge?

PROGRAM FOR EXPENDITURE REDUCTION

Mr. **Trowbridge**. Senator, I think we, too, would have difficulty in looking at a tax increase effective in 1984 as part of the answer. We did in February of last year outline a program for expenditure reduction applicable to the 1984 budget. I think it would be applicable to the 1985 budget, targeting a 25-percent reduction, or $50 billion reduction in the spending, with $18 to $22 billion of that coming out of defense and the balance coming out of nondefense and entitlement capping actions.

If you were to take the $50 billion reduction in spending as a viable project, possible to achieve in each of the 3 fiscal years, 1985, 1986, 1987, this could put you in the neighborhood of $150 billion deficit reduction over that 3-year period.

We are not unmindful of the very real political pressure to have a package which includes both revenue and expenditure cutbacks. It is the kind of thing where everybody shares the burden, and you know that that has to be. Our concern is that in the rush to find the tax increases this year, the pressures would be such that we accentuate a lot of problems in the existing tax code. What we would prefer is for Congress to spend this time looking at an overall reform, leading to action next year and, as I mentioned in my testimony, a real look at the consumption-based tax as an alternative.

Whether or not the $50 billion over each year for 3 years would result in an interest rate reduction, I think it would. It would attack in part this expectation level. It would be a concrete demonstration of the administration and the Congress ability to get the budget under control.

Senator **Gorton**. Thank you, Mr. Chairman. I interpreted that as yes, yes, probably no, and maybe.

Chairman **Domenici**. Senator Kasten, would you chair for me, since I have to leave? Senator Metzenbaum has properly called to my attention that you went over substantially, Senator Gorton, by asking a question that took 6 minutes after you asked it to answer. We are going to accordingly allow, be generous with you, Senator Metzenbaum.

Senator **Metzenbaum**. Thank you.

EXPECTATION KEEPING REAL INTEREST RATE OUT OF PROPORTION

Chairman **Domenici**. Before I leave, let me thank all of you for appearing. I will make this one observation. I think we had a group, Senator Chiles, of economists, I mean of brokers here one afternoon much like this in the middle of last year. They were sort of small placement officers on the street; they only had 300 or 400 million to place. One of them talked about this business of expectation that you are all worried about and put it in a very real way. He asked a question after speaking about the decade of the seventies in terms of the effect of inflation on bonds. He said, looking back on it, they now ask do you know how to become a millionaire in the decade of the seventies in the bond business? Nobody knew the answer. He said the answer is to start with 2 million.

If you are right, that is what you are saying is causing the real interest rate to be out of proportion. There is a lingering notion that you will get burned and burned bad, and the interest rate is not going to come down until that deficit is significantly reduced, or whatever it takes to get rid of the fear that they are going to get burned.

On the other hand, I do not understand how short-term interest rates are affected that way. And nobody can tell me why the short-term rates are not substantially lower.

Let me add this to the questions. If this committee comes up with a plan that we see a consensus for that is going to dramatically reduce the deficits and if it is bipartisan and is not consistent with what you polled your members on—I am not even asking Senator Chiles, but I think he agrees—we are going to get you in here? We are going to wait long enough for you to get out an urgent request so that we can see if they will not support it? We need your support if we are going to do this. We cannot have these two major groups over here 90 percent against the plan.

EXPENDITURE CUTS ALONE WILL NOT REDUCE DEFICIT

I can tell you right now that you are not going to get the deficits down with pure cuts on the expenditure side, not to where you all want them. I am just going to give you this so if your members ask you, you can tell them. If you want to balance the budget right now, you can do it very simply, if you assume this would all work macroeconomicwise. You leave the tax side alone. You pay for defense, as requested, as in the budget, with 5 percent growth. Pay for social security and the pensions and enough people to distribute the checks. And then you pay interest on the debt. And you stop. You close the rest of the Government down.

Now, there is not anybody sitting around here who is going to tell you that is good for the United States. That is no highway program. That is no medicaid. That is no food stamps. That is no water and sewer program. I mean, that is how you balance it. You just take those five items, and that is the budget right now, and that is the taxes that cover it. And the rest of it you just quit.

That is pretty tough medicine. Now, somewhere in between, obviously, you can begin to get there; but you are not going to get the $200 billion down with expenditure cuts unless you are prepared to reform social security again, before the ink is even dry on the current reform. And you would have to switch some of their taxes over into the general fund. That would have to be part of it.

I am going to let you all take over. Thank you.

Senator **Kasten**. Senator Metzenbaum?

ELIMINATE SALES OF CORPORATE TAX LOSSES

Senator **Metzenbaum**. Gentlemen, I hear all the speeches about what we ought to do. But I like Senator Gorton's procedure of asking you for yes or no answers. I will just ask you for a yes or no answer.

I will start with you, Mr. Carlson. Would you support eliminating sales of corporate tax losses through lease arrangements where one corporation does not need the tax losses and they sell them? By lease arrangement they are able to pass it on to another corporation.

Dr. **Carlson**. I would not care to answer it all or nothing, but I do think reform would be helpful in that area.

Senator **Metzenbaum**. How about you, Mr. Herder?

Mr Herder. I am not sure. I would have to ask staff where we are on that.

Senator **Metzenbaum**. Would you do that please?

Mr. **Motley**. A simple answer: Yes.

Mr. **Herder**. Yes.

Senator **Metzenbaum**. Mr. Trowbridge?

Did you say yes, Mr. Herder?

Mr. **Herder**. Yes, we could go along with it.

Mr. **Trowbridge**. I believe by and large we would, Senator. We obviously would have to review that in our policy, but I think by and large we would.

ELIMINATE DEPRECIATION RIGHTS ON OLD PROPERTY

Senator **Metzenbaum**. Good.

Now I will start with you, Mr. Trowbridge. Would you support elimination of the right of people who have bought old properties and add nothing to those properties and have the right under the present law to start depreciating them on an accelerated basis over a 15-year period?

Mr. **Trowbridge**. If that is an example of the 1981 tax act, in effect we would support continuation of that tax act, 10-5-3 proposals.

Senator **Metzenbaum**. This is not 10-5-3. This is, you and I own two properties. Mine is 50 years old. Yours is 60 years old. We meet at a cocktail party. I agree to buy yours. You agreed to buy mine. And now I start to depreciate your property that is already all depreciated out. I add nothing to it over a 15-year period on an accelerated basis, and you do the same with my property.

Do you think that ought to be eliminated? It adds nothing to the economy. There is no contribution of capital to the community. It makes somebody richer because they pay less taxes.

Mr. **Trowbridge**. Senator, I am obviously not a tax expert or attorney. I think it would be very hard for me to give you an answer on that, just cold as you are asking me to do so.

Senator **Metzenbaum**. Would you get me an answer please?

Mr. **Trowbridge**. Yes, sir.

[The following was subsequently supplied for the record:]

We cannot support such restrictions. In our view, the detailed "anti-churning" rules already contained in Internal Revenue Code Section 168(e)(4) are adequate to prevent abuse of this sort without unduly restraining the free transferability of property interests between related parties.

Senator **Metzenbaum**. Mr. Motley.

Mr. **Motley**. Senator, we do not have a position on that issue. But, if the membership's positions remain consistent, they would probably support doing away with that.

Senator **Metzenbaum**. Mr. Herder?

INCENTIVES TO INVEST NEEDED

Mr. **Herder**. Our answer is no. You have to move old housing stock in order to develop new housing stock. Direct expenditures for housing have been drastically cut in the budget by about 95 percent from 1980 to 1984. We need some incentives to invest. Really, that is what a tax shelter often is; it is an incentive to invest.

Senator **Metzenbaum**. Mr. Herder, this provides no incentive, because I am going to take my money, I tell you right now, I am going to buy my wife a new Mercedes Benz, and Mr. Trowbridge is going to buy his wife a new Rolls Royce. All that money is actually going to go overseas as a consequence. But it will add nothing to the real estate market at all.

Tell me how you think that that helps the realtor, other than saving the taxes.

Dr. **Carlson**. I would be opposed to it because——

Senator **Chiles**. The Germans might come over and buy one of our condominiums.

NEW USE BY OWNER COULD INCREASE PRODUCTIVITY

Dr. **Carlson**. I would be opposed to it because there is new use by the owner, and that could increase productivity. And also what you are suggesting is very bad for your constituency in Ohio because it would be a progrowth area part of the United States versus support of the infrastructure.

Senator **Metzenbaum**. Because it would what?

Dr. **Carlson**. You would create an incentive for people to build new as opposed to using the old or improving old or——

Senator **Metzenbaum**. No, I said no improvements, no improvements, Mr. Carlson.

Dr. **Carlson**. But there is new use. And there is higher productivity——

Senator **Metzenbaum**. My constituents who want this, and they tell me so, are the ones who are doing it; but there is not one of the tenants who cares about it because you have not done anything for him or her.

Dr. **Carlson**. On the average a purchaser usually has a higher productivity use for a structure that is being used. You deny that to the economy by having a different incentive for old versus new, and you would have more construction, more investment/ taking place in the growth areas of this country as opposed to Ohio.

Senator **Metzenbaum**. I want to say to you, Mr. Carlson, you are 100 percent wrong. Every realtor I talked to—and I talked to them because many of them are good friends of mine. They say to me without exception that we are doing it but it is absurd, it is absurd.

Dr. **Carlson**. The statistics on the average do not show the turnover of buildings is that great. You are talking about just a select few of your friends. Maybe those——

Senator **Metzenbaum**. No; I am not talking about a select few. I am talking about those I speak to all over the country. They tell me the same thing. I spoke in Clearwater the other day. The fellow who was driving me tells me he is in that business. He says it is crazy. He said, that is how I make my money and I really do not want to change, but I would understand if you changed it.

Dr. **Carlson**. Well, there is the problem at the margin that you used to have depreciation life that was much longer and inappropriate, given the inflation rate and obsolescence rates you have in this country. So, you have people shifting from the old depreciation schedule to another, but once you have a stable state, I would not expect that you would have that churning you are talking about.

Senator **Metzenbaum**. Well, I seem to have stepped on your toes. Let us go to something else that is not quite under foot.

ELIMINATE OIL COMPANIES' INTANGIBLE TAX WRITEOFF

Would you support elimination of the oil companies' intangible tax writeoff? No other corporations have it, Mr. Carlson.

Do you know the point that I am making?

Dr. **Carlson**. Yes, sir, I know it well.

I think that there should be an incentive for having more oil supply within the United States than from outside the United States. So, I would be a little hesitant on moving in that direction, though clearly that is one of the areas that should be reviewed.

Senator **Metzenbaum**. Mr. Herder.

Mr. **Herder**. We have no policy on this issue, Senator. Could I use my time to respond to your last question?

Senator **Metzenbaum**. Sure.

TENANTS BENEFIT FROM RENTAL HOUSING

Mr. **Herder**. I have read a HUD report that tenants can benefit from tax incentives. It says tenants are the primary beneficiaries of rental housing tax incentives. While owners receive the initial benefits of the tax provisions, the report explains, the enhanced return on investment will ultimately bring in more investors, resulting in lower rents.

Senator **Metzenbaum**. I have not seen any lower rents. You have not seen any lower rents. And I would venture to say—go ahead, Mr. Carlson, you are bursting at the seams—where are the rents being lowered?

Dr. **Carlson**. No, sir, it is true that any time that you provide an incentive to take care of existing property better, or to provide new, the incidence of that tax flows through in a competitive marketplace to the tenants over time. The fact of the matter is that rents have not gone up to account for the additional costs of constructing additional apartment units. Consequently, you really have had a bargain on the average across the country in the rental area. And that is one of the reasons why we have rental shortage at the present time. And rent controls, of course, hurt.

Senator Metzenbaum. But I have not seen much rent reduction. Mr. Motley.

Mr. Motley. Senator, I cannot recall NFIB taking a position on that issue. I would like to review the records and see if I can give you a yes or no answer. It may be there.

Senator Metzenbaum. Mr. Trowbridge.

Mr. Trowbridge. Senator, I think enhancing the domestic drilling of oil and gas is important, so we ought to maintain whatever incentives are in place to do just that. We cannot continue to rely on overseas sources for years to come. We ought to do whatever we can to encourage domestic drilling. I believe that provision of the tax law does that.

MINIMUM TAX ON CORPORATE PROFITS

Senator Metzenbaum. Mr. Trowbridge, would you support a minimum tax on corporate profits? If a company makes $2 billion, should it pay some taxes?

Mr. Trowbridge. My feeling is that part of being a citizen, either individual or corporate, is the responsibility to pay taxes. If a company uses the allowable tax law to reduce their various tax obligations and it is strictly within the spirit and the letter of the law, it seems to me that is the way they come out of the ball game.

Senator Metzenbaum. That is not what I asked you. Would you support a minimum corporate tax?

It would be a change in the law. I agree that they have a right to take advantage of the law that exists. Would you support changing it so that there would be a minimum corporate tax?

Mr. Trowbridge. I do not believe I would. No, sir.

Senator Metzenbaum. Mr. Motley.

Mr. Motley. Senator, if it was structured as a true minimum tax, yes. If it was structured as some of the others that have been under that name, no.

Senator Metzenbaum. Mr. Herder.

Mr. Herder. Yes, we probably would, but we really have to look at these collectively in order to make a determination.

Senator Metzenbaum. Mr. Carlson.

Dr. Carlson. I think it is much better to have a minimum personal income tax than a minimum corporate. In fact, I think we ought to do away with the corporate tax because the incidence falls on the workers and the owners, and you ought to tax them directly.

ELIMINATE ARTIFICIAL BAD DEBT RESERVE

Senator Metzenbaum. I have one last question. Mr. Carlson, most businesses have the right to set up a debt reserve. The debt reserve has to be commensurate with what their experience has been as far as bad debts are concerned. But banks have the right to set up an artificial debt reserve. As a consequence, the average tax of the largest banks in the country last year, the 20 largest, was 2 percent. Would you support eliminating the artificial bad debt reserve and make it just in accordance with reality?

Dr. Carlson. Some of the tax provisions have multiple objectives, such as savings and loans have a bad debt reserve. However, it is part of the incentive for savings and loans to stay in lending for housing. Consequently, you have to look at the impact of doing away with that bad debt.

Senator METZENBAUM. Answer it yes or no, Mr. Carlson.

Dr. CARLSON. The answer is, if you found a more efficient incentive for housing, I would support it; if you did not, no.

Senator METZENBAUM. Mr. Herder.

Mr. HERDER. I would echo Dr. Carlson's comments. If it has a beneficial effect for housing, we could support it.

Senator METZENBAUM. Well, you know. It has not had any. You have had this provision in the law for years, and you are not getting bank loans. When the rates are too high, you get them and you pay the higher rate. So, you are just whistling in the air when you tell me that if it did this. The fact is it is there. And the fact is that you cannot get good loans unless you pay a high price. So, what you are really saying is no, Senator, I am not willing to step on the toes of the banks because it just might in some way affect my industry.

What is your answer, Mr. Motley?

Mr. MOTLEY. We have no position on that issue.

Senator METZENBAUM. Mr. Trowbridge.

Mr. TROWBRIDGE. We have no position either, Senator Metzenbaum.

TRADE ASSOCIATIONS FAIL TO MEET TAX RESPONSIBILITIES

Senator METZENBAUM. Let me just point this out. I have other questions, but I do not want to impose upon the time of the chairman.

You want to balance the budget. Then you have to make some hard choices. And I asked you the questions, and I tried to make them some realtors and some corporate, in order to see whether or not you were willing to make the hard choices. Frankly, you ask the Members of Congress to make those choices, and I am willing to do it.

I would say to each of you, and so many other trade association executives throughout this country, or trade association officers, as the case may be, that you fail to meet your responsibility. You have to do what you said, Mr. Trowbridge. And that is, if you are making profits, you ought to pay a fair share of the tax burden. And none of you are willing to bite the bullet. Yet, all of you are willing to come here with thick speeches and tell us that we should do it. And I am willing to do it. And Domenici is willing to do it. And Chiles is willing to do it. And Kasten, I think, is willing to do it—I have not checked with him.

The fact is that many of us are willing to do it. You men, who make the speeches and who speak for the organizations are not willing to come in and step on the toes of those with whom you have lunch or play golf. And that is one of the problems of this country. Mr. Carlson for the rebuttal.

HALF OF HUD SPENDING PROGRAMS IDENTIFIED

Dr. CARLSON. It is not a fair statement. We have documentation that at the beginning of this administration we identified half of the HUD spending that affected our constituency and suggested that it be cut out.

Second, we have proposed to you that personal income taxes remain higher than they would otherwise be. That affects all of our constituents as well as the rest of the country across the board.

Third, what you are talking about in terms of loophole closing is peanuts, given $180 billion going up to $309 billion, according to the Congressional Budget Office. That will not close the deficits.

Fourth, most of the proposals you have suggested are antisavings and anti-investment. We are short on savings and investment in this country. We ought to be prosavings and proinvestment.

And the fifth issue, profits. I would not have profits as the measure for taxation. I would have income from those people who receive the benefit of the profits as a more appropriate way.

So, I take offense at what you are saying.

Senator METZENBAUM. I would say to you, Mr. Carlson, that I do not really believe you have responded accurately. I forget each of your five points, but give me the first one.

Dr. CARLSON. The first one, in 1980, 1981, we proposed to the Congress and to the administration and we wrote to every other trade association to do the same, that we all find programs that benefit us in the Federal Government and call for a cut in the spending of those programs. We went ahead and identified up to one-half of the spending programs in HUD. And I would be glad to give you that documentation.

Senator METZENBAUM. And the other?

Dr. CARLSON. The other point is we are, I am proposing that you do not have such large cuts in personal income taxes.

Senator METZENBAUM. Do away with indexation?

Dr. CARLSON. Modify it, I would dampen it. I would not do away with it.

Senator METZENBAUM. OK, I give you credit for that.

Dr. CARLSON. The point that bothers me about your proposals, almost every one of them is antisavings and antiinvestment.

Senator METZENBAUM. Do you mean to say that a minimum corporate tax is antisavings and antiinvestment?

Dr. CARLSON. Of course, it is.

OIL COMPANIES HAVE BEST TAX ADVANTAGES

Senator METZENBAUM. Do you mean to say a tax on making oil companies do the same things as others do?

Dr. CARLSON. Yes.

Senator METZENBAUM. They have got the best tax advantages of anybody in this country.

Dr. CARLSON. They certainly do.

Senator METZENBAUM. We do not get any more oil——

Dr. CARLSON. No, no.

Senator METZENBAUM. They make the biggest profits.

Dr. CARLSON. I disagree about the fact that we get more oil. I think we get more oil. But you are right, they have more preferential tax treatment. But face up to whether you want the oil within the United States or abroad. That is the issue, not the fat-cat nature of the particular tax proposal.

Senator Metzenbaum. Whether we want the oil——

Dr. Carlson. From drilling within this country, by having an incentive and thereby lowering the cost of drilling and finding oil in this country, as opposed to drilling and finding oil abroad.

Senator Metzenbaum. The oil companies would not go out of business if you change these. All they would do is they would pay a little bit more of their fair share of taxes. And they still would be one of the biggest corporate—they would be the biggest tax earners in this country anyhow; I mean the biggest earners.

Dr. Carlson. You are stopping with the intermediary, though, of companies instead of seeing where the source of oil would come. Many of these oil companies can drill abroad just as easily as they can here. Yet, the incentive for this country is to have the oil flowing from within the United States. So, you should not stop just with the intermediary that collects the tax. See what the incidence of that tax will be and whether that is harmful or not.

Senator Metzenbaum. Mr. Carlson, you are too smart to tell me that the oil companies are not going to drill in this country. It is far cheaper to drill here than to go overseas. But, unless we provide them with the foreign tax credits, which does make it advantageous to drill overseas——

Dr. Carlson. At the margin, it does matter what the costs are.

Senator Kasten. The Senator's time has expired.

Senator Metzenbaum. Could I just add something?

NAM SUPPORTED PASSAGE OF TEFRA ACT

Mr. Trowbridge. I would just like to comment, Senator. In 1982 the National Association of Manufacturers supported the passage of the TEFRA tax bill. We did so realizing that it did take back roughly 50 to 55 percent of those investment and savings stimuli that were passed in 1981. We did so because we were very concerned then about the mounting size of the deficit, mounting, and we felt that a balanced package was required. We did so also under the belief that there would be an approximate $3 of expenditure cutbacks for each $1 of revenue as a result of the passage of that act.

A good number of our members were not very happy with our posture on that. Nevertheless, we worked very hard in favor of that act. I do not think that that action complies with your description of being derelict in our responsibilities in an important area of trying to solve this deficit problem.

Senator Metzenbaum. That was a drop in the bucket. We have got so much more to do, Mr. Trowbridge.

Mr. Trowbridge. Well, sir, it was a big fight at the time, I remember that.

Senator Metzenbaum. Do not forget, we have already cut $491 billion in domestic spending over the fiscal years 1982–89 period. Congress has done its job pretty well, but we have also cut taxes about a $1,097 billion over that same period of time. And that is the reason, coupled with increased defense spending, that we cannot balance this budget.

TAX INCREASES FAVORED

Senator **Kasten**. I thank each of you for representing the private sector before this committee. It has been almost a week since the President presented his fiscal year 1985 budget to the Congress and the American people. I think that some of the discussion here has been most important. It is too bad that more people are not paying attention to your testimony.

I happen to agree, Mr. Trowbridge, with our call for spending cuts. During consideration of the debt bill last fall, I offered an amendment calling for the $3 that we were promised in spending cuts before we go with any more tax increases. And, I think everyone at this table supported that amendment, a number of you were interested in the Treasury's estimate that instead of the $3 of spending cuts promised in the fiscal year 1984 budget resolution, we have had a $1.17 spending increase during that time.

The fact is that the problem is spending. Congress has not been willing to bite the bullet, despite the fact that they signed off on last year's deal.

With the exception of NFIB, each your organizations—and NAR more strongly than the others—are in favor of revenue increases as part of a deficit reduction plan. Are you in favor, of those revenue increases because you think that they are politically expedient? Or do you think tax increases at this point are good economics, that they are going to somehow help the economy?

Dr. **Carlson**. I think that there is an element of what is feasible. But also I think it is good economics because we are talking about the tax burden being borne by those who primarily consume. And I am talking in terms of less consumption being available to those under the entitlement programs and less after-tax income for those who are paying the personal income taxes. I believe that is the way to solve the problem, as opposed to going with Senator Metzenbaum's loophole closing, which is primarily antisavings and antiinvestment.

So, I would argue both.

ENOUGH TAX INCREASES BUILT IN FOR GOOD ECONOMICS

Senator **Kasten**. Do you disagree with statements that in fact the tax legislation that has been passed subsequent to the Economic Recovery Tax Act of 1981 has reversed the tax cut? In other words that we reduced taxes in 1984 and since then we have raised taxes with the gas tax, TEFRA, and increases in social security. The result has been virtual elimination of the tax cuts. Do you not think we have got enough tax increases already built in for good economics?

Dr. **Carlson**. If you asked me if I could redesign where we are at the present time, I would not end up with this deficit. But you folks did and the President did. We have got a problem. How are we going to solve it? I know of no way that you can get this job done without doing something on the personal income tax side as well as on the entitlement side. And that is where most of your sensitivity is, as well as capping defense and continuing with the low growth of the nondefense side.

Senator KASTEN. Mr. Herder, do you believe that increasing taxes is good economics? Or are you simply trying to figure out a way to get some package through the Congress?

Mr. HERDER. We are simply trying to figure out a way to get at that $200 billion deficit. Realistically, going along with what Chairman Domenici said, we feel it is the only way we can do it.

Senator KASTEN. But I think you all ought to recognize we tried that once. You know, it fooled me once. But now, instead of 3 to 1 spending cuts, now we are 1 to 1.

Mr. HERDER. Well, 1 to 1, at least, yes.

Senator KASTEN. But if we start in now with $1 of spending cuts for $1 in tax increases, do you think this will solve our problem? Is that going to solve our deficits?

Mr. HERDER. No; I think it is just going to show a direction that you are moving in. That would be a positive direction. It is not going to solve it right away.

Senator KASTEN. But the ratio has got to be an awful lot different than 1 to 1, as we look out toward the future with some of the deficits that you have talked about in your testimony. Do you agree with that?

Mr. HERDER. Yes.

EMPHASIS CLEARLY ON SPENDING SIDE

Senator KASTEN. We have got more emphasis on the spending side of the budget.

Mr. HERDER. I would agree with that.

Senator KASTEN. Mr. Trowbridge?

Mr. TROWBRIDGE. Senator, if I could just go back to page 2 of my testimony, quote: We are pleased that the President is proposing no major tax increases. We strongly agree with the President's position that major tax increases at this time, when some parts of the economy have yet to really come out of the recession, are not appropriate.

And on page 7: In recognizing the possibility that the Congress may be forced to accommodate a package of combined revenue increases and spending reductions, I said, should something of this sort occur again, we strongly urge that any such package be structured so that on an annual basis no tax increase will go into effect until there has been an objective certification that planned spending cuts have already occurred.

So, the emphasis is clearly on the spending side.

TAX SIDE NOT NECESSARILY GOOD ECONOMICS

Senator KASTEN. Is it fair to say that NAM looks at the tax side as not necessarily good economics, but at the revenue increases as expedient politics?

Mr. TROWBRIDGE. The object being to get the budget deficit down, we recognize that that expedient may well be necessary sometime in the future.

Senator KASTEN. Mr. Motley?

Mr. MOTLEY. Senator Kasten, the deficit is such a problem, I would like to simply reiterate what I said before in terms that I do not think we would discount anything off the top. We do feel very,

very strongly that the spending side has to be much more heavily considered than the taxing side. Very frankly, as far as NFIB is concerned, we would rely very heavily upon you and Senator Armstrong and others who believe the same thing to indicate when those spending cuts were real and large enough to proceed with a compromise.

Dr. **Carlson**. May I just add?

Senator **Kasten**. Yes.

Dr. **Carlson**. I think it is important to get the quid pro quo that we missed in 1982. The only way that I know you can do it is through one act, is through the adjustment on the COLA's, the CPI minus 1, 2, or 3, whatever you want to do. You get it on both the spending and the tax side, and you are not caught short as you were before.

Second, I have been greatly disappointed with the tax cuts, and the accumulation of increases since then. The net effect of the 1981 and later acts has been the proportion of the cuts going to stimulate savings and investment had been the longest proportion of any major tax cut in postwar history—about 18 percent. The average in the postwar years was 25. The Kennedy-Johnson one was 33 percent. So, it is proconsumption. It was not prosavings and proinvestment. And we continue to be short on the savings and investment side.

That is why I think we have to favor that very carefully.

Also, I agree with you. The social security solution was a protax approach, about 90 percent, that will be the tax increase, as opposed to some sort of a quid pro quo. It solved the problems, but it did not do them very well.

Senator **Kasten**. On behalf of the committee, I would like to thank all of you for your testimony here today. There may be written questions that will come to you from members of the committee. Hopefully, you can respond to those questions in a latively short period of time.

Thank you very much for your testimony. The committee is adjourned.

[Whereupon, at 3:35 p.m., the committee was adjourned.]

VIEWS OF THE CONGRESSIONAL BUDGET OFFICE

WEDNESDAY, FEBRUARY 8, 1984

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 9:45 a.m., in room 608, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Quayle, Gorton, Chiles, Biden, and Exon.

Staff present: Stephen Bell, staff director; and Gail Fosler, chief economist.

For the minority: Richard N. Brandon, staff director; and Garry Schinasi, senior economist for macroeconomic and fiscal policy.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman DOMENICI. We are going to get started.

I understand, Dr. Penner, that a number of Senators will be in and out, but we very much want to get your testimony on the record. We are going to have 8 or 9 Senators, 10 maybe, in and out and we will try to accommodate them.

It is a pleasure to welcome you to the committee. This is only your second appearance before this committee since assuming your role. You testified very briefly on your first appearance, so I almost consider this to be your opening appearance before the Budget Committee of the Senate.

ECONOMIC YEAR TURNED OUT GOOD

Now, we know that there has been a lot of doom and gloom in the financial markets this week. Your economic report, in spite of that, is pretty upbeat in terms of unemployment, inflation, and interest rates.

I think the point is well made in the report that for all the worry of last year, this turned out to be a good year. Indeed, business equipment investment and housing came back with strength that very few predicted.

Even with all this good news, we know that there is a very major problem, and certainly you address it very forthrightly and honestly from what I know of your report, and it will not come as any surprise. You came here to describe it. We already know what it is; we know its dimensions.

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What worries me is that there is a certain sense of hysteria about the budget deficits, and I will wait until you have testified and then I will ask you to do some comparing for us in terms of periods of economic risk and what the characteristics of the risks were.

The cause of the problem is simple. Revenues are too low; spending is too high. We spent a lot of time debating whether it is spending that should be reduced or revenues that should be raised. I do not think there is any doubt that anyone looking at this budget would have to conclude that the answer is both.

There are some who would choose one over the other, but if you are realistic, the answer is both. In a sense, that makes the task very difficult because some would want all of one and none of the other, and vice versa.

ECONOMY IS NOT HELPING THE PROBLEM

Policy is only part of the problem. The economy is not helping. Your report shows that the congressional policies during the past year reduced the budget deficits, but that the economy offset almost all of Congress efforts.

Lower oil prices and higher interest rates than we expected last year, not congressional policy actions, account for about 90 percent, from what we can determine, of the rise in the current deficits, if you want to call them current policy deficits.

I repeat again today that for those who talk about the deficit with some degree of hysteria, clearly we have an opportunity to begin to reduce the deficits. If $100 billion is not enough, let us try for more.

Certainly, today I am optimistic that we can get that started, but it is really up to five or six people here on the Hill and in the White House, and hopefully the President will get involved and that will get it started.

In that spirit, I will make additional remarks a part of the record and proceed to ask Senator Chiles if he has any opening remarks. Then we will call on you, Dr. Penner.

[The prepared statement of Chairman Domenici follows:]

Prepared Statement of Chairman Domenici

It is a pleasure to welcome you to this Committee, Dr. Penner. This is only your second appearance before this Committee since assuming your role as CBO Director and your first appearance was very brief. Your testimony last November was just a preview. Consider today your opening.

Despite all of the doom and gloom in financial markets this week, your economic report to the Congress is pretty upbeat. Unemployment is down; inflation is down; interest rates are pretty flat. For all of our worry last year, this turned out to be a very normal recovery. Indeed, business equipment investment and housing have come back with surprising strength.

Even with all these good things, we know we have a problem. Your statement to this Committee today will indeed come as no suprise. You have come here to describe it. But we already know what it is. And we know its dimensions. What worries me is that I sense a certain hysteria about the budget deficits. I will ask you later in your testimony if the deficit problem we face is any more threatening than the inflation crisis we faced in the late 1970s.

The cause of the problem is simple. Revenues are too low. Spending is too high. We have spent a lot of time debating whether it is spending that should be reduced or revenues that should be raised. The answer is both. And we will get on to that task.

But, policy is only part of the problem. The economy is not helping. Your report shows that Congressional policies during the past year reduced the budget deficits but that the economy offset almost all of our efforts. Lower oil prices and higher interest rates than we expected last year—not Congressional policy actions—account for almost 90 percent of the rise in the current policy deficits.

As I have said many times in the past two weeks, the President's willingness to negotiate with both parties and both Houses in Congress offers us an extraordinary opportunity. We have a reconciliation bill on the floor, now, which contains several of the President's own proposals. This represents an important foundation for a $100 billion bipartisan package as a downpayment on future deficit reduction. Frankly, Dr. Penner, I am optimistic.

We will not solve the whole budget problem this year or probably even next. After we act, budget deficits will still be very, very high. But we will make a substantial start. This Congress will enact a larger package of deficit reductions than anyone thought possible a year ago. and we will do it with patience, by working together and by setting election year rhetoric aside and getting on with it—as they say.

So in this spirit, Dr. Penner, let's get on with your testimony. We look forward to your testimony with great interest.

Chairman DOMENICI. Senator Chiles?

OPENING STATEMENT OF SENATOR CHILES

Senator CHILES. Thank you, Mr. Chairman.

Dr. Penner, we are delighted to have you with us. The Congressional Budget Office is known for its professional approach You use realistic numbers and temperate language. But in your detached way, you tell us that the 1989 Federal deficit will grow to $326 billion under current tax and spending policies.

Those numbers ought to scare the living daylights out of reasonable men and women. They certainly scare the devil out of me. Nevertheless, I am afraid your Economic Outlook is an objective appraisal of the budget, with the politics bleached out.

When Secretary Regan appeared before this committee last week, he said we could throw the President's economic report in the trash, and your estimate tells me that we really might as well do the same thing with the President's budget. I really do not say that facetiously, and I do not say that just for rhetoric's sake.

Your deficit estimates assume that taxing and spending policies remain basically unchanged through 1989. Regrettably, that is approximately the same conclusion that we have to derive from the President's budget.

By standing pat and recommending no significant changes in the path of rising military costs or declining revenues, the budget virtually guarantees the deficits you project. The only difference is you use more realistic economic projections than are found in the President's budget.

Your report, doctor, presents a wealth of material, but I think very special attention should be drawn to the table on page 115 of part 2 of your study. As I add up the figures across the years, I find that nondefense spending is reduced by $491 billion. Military spending, however, rises, and this is by 1989, to a total of $317 billion.

[The table referred to follows:]

EFFECT ON DEFICITS OF POLICY CHANGES SINCE 1981

[By fiscal year, in billions of dollars]

	1982	1983	1984	1985	1986	1987	1988	1989
Deficit (−) or surplus under policies in effect Jan. 1, 1981	−109	−149	−111	−83	−63	−39	−17	11
Legislative changes:								
Tax reductions	−40	−73	−93	−117	−151	−180	−204	−239
Defense spending increases	−1	−17	−25	−36	−42	−54	−65	−77
Nondefense spending cuts	39	46	48	59	71	74	76	78
Effect of legislative actions on interest costs	(*)	−2	−9	−19	−32	−49	−72	−100
Total changes	−2	−47	−79	−112	−154	−209	−264	−337
Deficit under policies in effect Jan. 1, 1984	−111	−195	−190	−195	−217	−248	−282	−326

Source: Congressional Budget Office, "Baseline Projections for Fiscal Years 1985–89," February 1984, p. 115.

Senator **Chiles**. So if you subtract the defense additions from the domestic spending cuts, we get a net reduction in spending of $174 billion. The bad news is that the tax cuts over the same period cost almost $1 trillion. Taxes were cut $923 billion more than spending, so the net result is $100 billion per year in additional interest payments by 1989.

That is very interesting. If you add together the tax reductions and the military spending increases, then something around $1.4 trillion is added to the deficit by 1989. Yet, the White House tells us that we need more nondefense spending cuts that will take care of our problem—the same category that has actually been reduced by $491 billion, according to the table that you have presented.

I think the message is crystal clear. We have to hold the line on nondefense spending. Maybe we can get some more cuts there, but we have to look to the sources of the deficit for the answers to the deficit problem.

If I can make just a few additional points based on your report, to begin with deficits are going to continue to keep interest rates high. Your report also notes that housing starts stalled last fall and residential construction activity declined in the final quarter of 1983.

Your report points out, "The outlook for further growth in the construction sector now depends critically on the future course of interest rates and the resolution of the budget deficit problem."

I cannot agree more, and we had a panel yesterday of housing people that said exactly the same thing. Second, your report also emphasizes the effects of our high deficits and interest rate on the trade deficit. It is costing us jobs and threatening our continued economic growth in a highly competitive world economy.

TIMING IS IMPORTANT TO DEFICIT DILEMMA

Finally, timing is important to the deficit dilemma. I want to quote one more time from your report where it says, "If the policy changes are delayed until 1985, they are not likely to affect revenues and outlays significantly until 1986 or later, increasing economic uncertainty."

Those observations amount to marching orders for the President and the Congress as we decide whether to take on deficit reduction efforts this year. We have to understand that the deficits are keeping interest rates high. Military spending and lower revenues are the primary sources of the deficit, and with entitlement spending contributing to the problem, then the deficits must be cut and we have to do that now.

That, it seems to me, is the story of your analysis in a nutshell. I am looking forward to your testimony and I hope what you have to say, together with what is in your report, will have a sobering effect on all of us.

That is so necessary because many times anything we say, even though it is often said by the chairman and myself, still somehow is just termed "political talk."

Thank goodness CBO has the reputation, and you are continuing it, of trying to be a step back from any political rhetoric, just trying to look at what the facts show us.

Chairman DOMENICI. Thank you, Senator.

Dr. Penner, you may proceed.

STATEMENT OF DR. RUDOLPH G. PENNER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Dr. PENNER. Mr. Chairman, Senator Chiles, I am very pleased to have this opportunity to testify on the economy and the Federal budget. We have distributed to you the two reports, some of which Senator Chiles just quoted.

Today, we are releasing the thicker volume, on reducing the budget deficit, which has a number of options in it. I will discuss that in general later.

CONDITION OF ECONOMY IMPROVED SINCE RECESSION

As the chairman suggested, the condition of the U.S. economy has improved markedly since the recession. Output grew vigorously during the first year of recovery and the unemployment rate declined at a near record pace from a level that was a post-World War II high. At the same time, the dramatically lower inflation rates that were achieved during the recession held firm in 1983 despite the pace of the recovery. At the end of 1983, economic growth appeared to be slowing, as is normal in the second year of a recovery.

In one respect, however, the recovery was unusual. Interest rates remained at very high levels, apparently because of huge current and prospective Federal deficits and the anti-inflationary policies of the Federal Reserve. As a result, some sectors—particularly the export and import-competing industries—did not fully participate in the recovery.

Despite the high interest rates and signs of unbalanced growth, most forecasters, including CBO, believe that the near-term outlook remains favorable. The consensus forecast calls for economic growth in the 4- to 5-percent range during 1984, with inflation only slightly above the previous year's rate.

UNCERTAINTY CLOUDS HORIZON

But the horizon is clouded by the uncertainty concerning Federal economic policy.

Some have questioned whether continued recovery is possible, given the huge deficits implied by current fiscal policy. Our own forecast implies that the economy can continue to expand robustly in the short run despite the level of Federal borrowing. The real harm done by deficits involves a negative impact on long-run growth, and therefore on future living standards. In other words, the process is gradual and there is no easily, identifiable, traumatic event that clearly illustrates the effects of deficits. There is an intense conflict between public and private borrowing needs, but the word "collision," which is often used to describe this clash, may not be exactly appropriate. A collision is a readily observable, violent event. The gradual erosion of our future prospects is much harder to detect.

However, more than the usual degree of uncertainty must be attached to the short-run forecast in the foregoing analysis. CBO projects Federal deficits rising from $190 billion in the current fiscal year to $326 billion in 1989, if budget policies are not changed. The projections imply that deficits will average 4.7 percent of gross national product (GNP) during the 1980's. The comparable levels in previous decades were 0.4 percent in the 1950's, 0.8 percent in the 1960's, and 1.9 percent in the 1970's. We are operating so far outside the range of recent historical experience that any analysis must be put forward tentatively, and the risks are enormous even in the short run.

My prepared testimony describes in some detail recent economic developments. I will just skip over that for now, if you do not mind, and I would be pleased to take questions on that later if you would like.

THE CBO ECONOMIC PROJECTIONS

The CBO baseline economic projections, which are used to generate baseline budget estimates, they consist of two parts: first, a short-run forecast for the 1984-85 period, conditional on specific policy assumptions; and, second, longer run projections based upon historical growth trends and the assumption that inflation will gradually decline.

SHORT-RUN BASELINE FORECAST

The short-run baseline forecast incorporates the following policy assumptions. The Federal budget policies are those currently in place. Defense authority, in real terms, increases at roughly a 5-percent rate. Budget outlays are $853 billion in fiscal year 1984 and $928 billion in fiscal year 1985.

Federal Government revenues are those associated with current tax law: $663 billion in fiscal year 1984, and $733 billion in 1985. Growth in the M1 money aggregate is assumed to be 6 percent over the four quarters of 1984—that is, right in the middle of the range that Chairman Volcker announced yesterday—and 5.5 percent during 1985.

The forecast also assumes that there will be no price shock, or credit crises such as might be related to an LDC debt crisis. Retail food prices are assumed to increase at about 4 percent in 1984 and 5 percent in 1985, reflecting the delayed effect of last summer's drought. Crude oil prices are assumed to remain constant at about $29 per barrel throughout the forecast period.

With these assumptions, real GNP is projected to rise 4.7 percent over the four quarters of 1984, and 3.7 percent during 1985. Average growth over the 2 years is slightly above the average for the second and third years of previous recoveries. The civilian unemployment rate is projected to decline from 8.5 percent in the last quarter of 1983 to 7.6 percent by the end of 1984, and to 7.1 percent by late 1985.

As measured by the GNP deflator, inflation is expected to accelerate slightly from 4.2 percent to 5.3 percent in 1984, compared to 1983, and to average 5.1 percent during 1985. This increase in inflation reflects temporary factors, and nothing in the CBO forecast is inconsistent with the hypothesis that inflation is on a long downward trend.

The 3-month Treasury bill rate is projected to average 8.9 percent this calendar year and slightly lower next year. Interest rates remain very high in real terms because of the exceptionally large amount of Treasury borrowing, combined with strengthened private credit demand.

LONGER RUN ECONOMIC PROJECTIONS

The baseline economic projections for the 1986-89 period assume moderate noncyclical growth in output averaging about 3.4 percent per year. The projections for the long run are based on historical trends and are not meant to be necessarily consistent with the policies now in place. Unemployment declines gradually to 6.5 percent by the last year of the projection. Inflation declines very gradually from 5.1 percent in 1985 to 4.3 percent in 1989, and interest rates decline with inflation. This may be somewhat optimistic, since analysis based on past experience suggests that the inflation rate might cease its decline, given the assumed reduction in the unemployment rate. However, the relationship between unemployment and inflation is highly unstable, and it is our judgment that, if unemployment falls smoothly and slowly—as is implied by our growth path—continued progress can be made against inflation.

Since a longer term projection of real growth is based on historical trends, it is not intended to be an implicit judgment about what would be appropriate growth. For the 7-year period beginning with the recession trough—that is, in the last quarter of 1982—growth in real GNP is assumed to average 4 percent in this baseline projection, precisely the same as the average growth rate during the first 7 years following previous post-war recessions.

UNCERTAINTY IN ECONOMIC OUTLOOK

There is a great deal of uncertainty in the economic outlook, particularly with respect to inflation and interest rates.

With regard to fiscal policy, the major question is whether deficits will be reduced soon and, if so, how? It is difficult for businesses and individuals to make effective decisions about the future without knowing what deficit-reducing measures will be taken what the impact these measures are likely to have on their activities. Moreover, the competition between private and Federal credit demands will be intense if policies are not changed. Federal borrowing will decline relative to GNP only in the first years of the projection, and then only slightly, and it will remain exceptionally high and increase relative to GNP in later years.

If action on the deficit is postponed, it is also possible that foreigners will lose confidence in U.S. policies and reduce their investments in this country. While the resulting decline in the exchange value of the dollar would benefit U.S. export and import-competing industries, it would also generate increased domestic inflation and— given a fixed rate of money growth—push up interest rates. It may even force the Federal Reserve to undertake a more restrictive policy in order to maintain stability in foreign exchange markets.

THE BUDGET OUTLOOK

Given the baseline economic assumptions and no change in the budget policies now in place, CBO estimates that the Federal deficit, as I said before, will rise from about $190 billion this year to $326 billion in fiscal year 1989. Despite rapid growth in GNP, the budget deficit rises from 5.3 percent of GNP in 1984 to 6.1 percent in 1989, matching the record level established last year.

Federal spending remains very strong in the baseline projection. Relative to GNP, it declines from 24.7 percent in 1983 to 23.9 percent this year, but then rises to a new record high by 1989. Revenues are projected to be 18.6 percent of GNP in fiscal 1984, rising gradually to about 19 percent in 1988.

CHANGES IN THE COMPOSITION OF REVENUES AND SPENDING

The composition of Federal revenues is projected to change only moderately over the next 5 years. Changes in the composition of Federal spending are more substantial. The most rapidly growing category of spending in the baseline is net interest. With large and growing deficits and no reduction in inflation-adjusted interest rates after 1985, Federal borrowing costs are projected to double over the next 5 years. The portion of gross spending excluding offsetting receipts, devoted to interest rises from 12 percent in 1984 to 16 percent in 1989. Defense spending grows by 79 percent between 1984 and 1989, assuming real increases of 5 percent per year. The share of defense spending in the budget grows from 26 percent to 30 percent.

In our projections, domestic spending—the combination of entitlements and discretionary programs—grows by 38 percent between now and 1989. Because this is well below the rate of increase in total outlays, their share of the budget declines from 62 percent in 1984 to 55 percent in 1989. The dollar increase is still substantial, however, from $556 billion in 1984 to $769 billion in 1989. Of this $213 billion increase, it is important to point out, $124 billion, or 58 percent, is in just two programs, social security and medicare.

Indeed, I think the most important point illustrating the difficulty of the long-run problem is the fact that very few programs will be responsible for the bulk of Federal outlays over the projection period. Our projections suggest that, by 1989, spending on defense, social security, medicare, and net interest will be equivalent to almost 100 percent of projected tax receipts.

The next part of my prepared testimony compares our assumptions to the administration's. I will certainly be glad to go into that later. Let me skip to some remarks on the consequences of large deficits.

CONSEQUENCES OF LARGE DEFICITS

Federal deficits of the magnitude shown in the baseline projections would have major consequences both for the economy and for future budget choices. Most economists agree that Federal deficits of the size projected by CBO keep interest rates higher than they would be otherwise. The effect would be particularly strong as the economy approached full employment or the limits to growth set by monetary policy. In that case, public and private borrowing would compete for a relatively fixed level of savings. Even in the present situation of less-than-full employment, deficits are likely to raise interest rates. A few analysts contend that there is no historical evidence for a link between deficits and interest rates. But one should not expect to find in historical data a simple association between the two variables. Previous deficits experienced during peacetime have been much smaller than those now projected, and their impact on interest rates has often been overwhelmed by recessions, Federal Reserve policies, or international capital flows.

The current and prospective deficits are extremely large relative to past history. In fiscal year 1983, the Federal deficit was about 107 percent of domestic net private savings and 34 percent of gross private saving. Our forecast implies that the situation improved somewhat, but the deficits would be 79 percent of net private saving and 29 percent of gross private saving during the fiscal years 1984 and 1985. Fortunately, very large capital inflows from abroad have so far limited the rise in interest rates. It should be emphasized that these capital inflows are not a costless remedy for deficits. If the capital inflow continued for a long time, foreign claims on U. S. output, in the form of interest and dividends, could rise to such a level that it would reduce our standard of living significantly below what it would be if we decreased government borrowing and relied less on capital inflows.

THE INTEREST PAYMENT BILL

The most striking feature of the CBO budget baseline projections—.

Chairman **Domenici**. Is that last one just because they literally take the money out?

Dr. **Penner**. Simply because we have got to pay them on all of the money we are borrowing—that is, pay interest and dividends.

Chairman **Domenici**. And that is different than interest we pay to ourselves?

Dr. **Penner**. Yes, it is, in the sense that what we have to do to pay the interest abroad in the longer run is to raise our export surplus. That in turn gives Americans, in total, fewer goods and services that they can consume.

The most striking feature of the CBO budget baseline projections is the extremely rapid growth in outlays for interest on the debt. Net interest costs, which were between 1 percent and 2 percent of the GNP for decades, are projected to rise from 2.8 percent of GNP in fiscal year 1983 to 4.1 percent in 1989. In these circumstances, major spending cuts or tax increases are necessary just to avoid the possibility of explosive growth in interest outlays.

The rapid rise in the debt-to-GNP ratio also makes the future deficit outlook highly sensitive to interest rates, one of the hardest variables to forecast. A 1 percentage point error in the forecast, if continued through the projection period, implies a $30 billion error in the projection of the 1989 deficit.

REDUCING THE DEFICIT

I am pleased to be releasing today before this committee part III of CBO's annual report on options for reducing the deficit. This is the fifth in a series of studies that presents options—not recommendations—for cutting spending or raising taxes. There is really no adequate way to summarize the approximately 138 options presented—that is, 98 on the spending side, 40 in revenues—but perhaps I can give some flavor of the analysis by culling one highlight from each substantive chapter.

In national defense, the options discussed contrast the difficult trade-off between short-term readiness efforts and long-term buildup of conventional and nuclear weapons systems, with the sobering conclusion that to bring the administration's defense budget down to 5 percent real growth, the rate incorporated in last year's budget resolution, will require $174 billion in cuts from defense budget authority between 1985 and 1989, using the administration's defense price assumptions. To freeze defense budget authority at the 1984 level, adjusting only for inflation—will take cuts of over $400 billion in the next 5 years.

In medicare and medicaid, the CBO analysts illustrate each of the variety of ways that Federal costs can be held down: by restraining payments to hospitals and doctors, by making patients or taxpayers pay more, or by shifting more of the cost to State and local governments. A key factor in cost control and in the solvency of the medicare program will be how well the new prospective payment system works. It is much too early to tell.

Social security and other entitlements (including agricultural price supports) are such a large part of budget outlays that a wide variety of proposals is already on the table. Our options cover limits on cost-of-living adjustments (COLA's), reductions in eligibility for some entitlements, restraints on Federal employee retirement, and significant reductions in crop price supports.

The remainder of the noninterest budget—nondefense discretionary programs—is made up of hundreds of relatively small accounts. Correspondingly, each option discussed in this section of our study yields relatively small budgetary savings. To close a substantial fraction of the deficit from cuts in these programs would require moving on many fronts at one time.

REVENUE RAISING OPTIONS

Our study concludes with a discussion of revenue raising options. Here, we have made a distinction between relatively small, specific changes in the Tax Code that, even if packaged together, would raise only relatively small sums (these are listed as options starting on page 199) and the bigger steps that could be taken to modify our tax system to raise yields. These latter—including major base-broadening, surtaxes, dropping indexing, and consumption taxes—are discussed in the body of chapter VI.

The analysis clearly brings out the difficulty of resolving the budget dilemma. The fact is that all spending does some good for someone and all taxes do some harm to someone, so there is never a good spending cut or tax increase in the eyes of the entire electorate. Nonetheless, our budgetary predicament requires that we make difficult choices and search for the least damaging package of deficit reduction options that can command majority support. I hope our discussion helps this search.

Chairman DOMENICI. Very good, thank you.

[The prepared statement of Dr. Penner follows:]

PREPARED STATEMENT OF DR. RUDOLPH G. PENNER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. Chairman, I am pleased to have this opportunity to testify on the economy and on the federal budget. We have distributed to you the three parts of the Congressional Budget (CBO) annual report. Part I on the economy and Part II on the budget were released yesterday. Part III, Reducing the Deficit: Spending and Revenue Options, is being released today. 1/

As you know, the condition of the U.S. economy has improved markedly since the recession. Output grew vigorously during the first year of recovery, and the unemployment rate declined at a near record pace from a level that was a post-World War II high. At the same time, the dramatically lower inflation rates that were achieved during the recession held firm in 1983 despite the pace of the recovery. At the end of 1983, economic growth appeared to be slowing, as is normal during the second year of a recovery.

In one respect, however, the recovery was unusual: interest rates remained at very high levels, apparently because of huge current and prospective federal deficits and the anti-inflationary policies of the Federal Reserve. As a result, some sectors--particularly the export and import-competing industries--did not fully participate in the recovery.

Despite the high interest rates and signs of unbalanced growth, most forecasters, including the CBO, believe that the near-term outlook

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1/ Congressional Budget Office, A Report to the Senate and House Committees on the Budget, Part I: The Economic Outook, Part II: Baseline Budget Projections for Fiscal Years 1985-1989, Part III: Reducing the Deficit: Spending and Revenue Options (February 1984).

remains favorable. The consensus forecast calls for economic growth in the 4 to 5 percent range during 1984, with inflation only slightly above the previous year's rate. But the horizon is clouded by uncertainty concerning federal economic policy.

Some have questioned whether continued recovery is possible given the huge deficits implied by current fiscal policy. Our own forecast implies that the economy can continue to expand robustly in the short run despite the level of federal borrowing. The real harm done by deficits involves their negative impacts on long-run growth and, therefore, on future living standards. In other words, the process is gradual and there is no easily identifiable, traumatic event that clearly illustrates the effects of deficits. There is an intense conflict between public and private borrowing needs, but the word "collision," which is often used to describe this clash may not be exactly appropriate. A collision is a readily observable, violent event. The gradual erosion of our future prospects is much harder to detect.

However, more than the usual degree of uncertainty must be attached to the short-run forecast and the foregoing analysis. CBO projects federal deficits rising from $190 billion in the current fiscal year to $326 billion in 1989 if budget policies are not changed. The projections imply that deficits will average 4.7 percent of the gross national product (GNP) during the 1980s. The comparable levels in the previous decades were: 0.4 percent in the 1950s, 0.8 percent in the 1960s, and 1.9 percent in the 1970s. We are operating so far outside of the range of recent historical experience that any analysis must be put forward tentatively and the risks are enormous, even in the short run.

RECENT ECONOMIC DEVELOPMENTS

Output rose 6.1 percent during 1983, close to the average of previous postwar recoveries. The cyclical upturn in output began in the first quarter of last year, following a rebound in residential construction and consumer spending and an abrupt decline in inventories in the fall of 1982 (see Table 1). The impetus for this improvement in household demands was the easing of monetary policy beginning in the summer of 1982 and the cuts in income taxes. Defense spending also grew rapidly in 1982. Higher demands caused industrial production to increase sharply (16.1 percent) during 1983, and by year-end capacity utilization in manufacturing had risen from a post-World War II low of 68.8 percent to 79.4 percent. Business investment spending turned up in the second quarter of 1983 and grew rapidly in the second half of the year in response to rising capacity utilization and to the net stimulative effects of the business tax legislation of 1981 and 1982.

Unemployment and Inflation

The unemployment rate declined dramatically last year, from the postwar record of 10.7 percent of the civilian labor force to 8.0 percent at the beginning of this year. The decline was much sharper than warranted by the increase in output, given past experience. In the first year of recovery, the labor force grew less than expected and growth in employment was

TABLE 1. RECENT ECONOMIC INDICATORS (Percent change from previous period at seasonally adjusted annual rates, unless otherwise noted)

				1982		1983			
	1981	1982	1983	Q3	Q4	Q1	Q2	Q3	Q4
Real GNP	2.6	-1.9	3.3	-1.0	-1.3	2.6	9.7	7.6	4.5
Final sales	1.8	-0.7	2.8	-1.5	4.5	0.6	6.8	5.1	3.5
Consumption	2.7	1.4	4.2	0.9	3.6	2.9	10.0	2.2	6.5
Business fixed investment	5.2	-4.7	1.1	-8.8	-6.6	-1.5	7.9	18.7	22.3
Residential investment	-5.2	-15.4	39.6	-13.0	53.2	57.3	79.5	35.9	-5.2
Government purchases	0.8	1.8	0.5	9.4	10.6	-8.8	-1.1	4.4	-2.7
Inventory Change (billions of 1972 dollars)	8.5	-9.4	-2.4	-1.3	-22.7	-15.4	-5.4	3.8	7.5
Net Exports (billions of 1972 dollars)	43.0	28.9	11.7	24.0	23.0	20.5	12.3	11.4	2.5
Industrial Production	2.7	-8.2	6.6	-3.4	-8.4	10.1	18.4	21.8	11.6
Capacity Utilization (percent)	80.2	72.1	75.4	71.7	69.8	71.2	73.9	77.3	79.1
Payroll Employment (millions)	91.2	89.6	90.0	89.3	88.8	88.8	89.5	90.3	91.4
Civilian Unemployment Rate (percent)	7.6	9.7	9.6	10.0	10.6	10.4	10.1	9.4	8.5
Inflation Rate									
CPI-U	10.4	6.1	3.2	7.7	1.9	-0.4	4.3	4.7	4.9
GNP deflator (fixed weight)	9.5	6.4	4.3	5.9	4.7	3.4	4.3	4.7	4.5
Productivity a/	1.9	-0.1	3.1	2.3	1.3	3.7	7.1	2.3	1.0
Interest Rates (percent)									
Treasury bill rate	14.0	10.6	8.6	9.3	7.9	8.1	8.4	9.1	8.8
Corporate AAA bond rate	14.2	13.8	12.0	13.8	11.9	11.8	11.6	12.3	12.4

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Board; Moody's Investors' Service.

a/ Output per worker hour, nonfarm business sector.

exceptionally rapid. In consequence, the rebound in productivity was somewhat less than in the normal cyclical rebound.

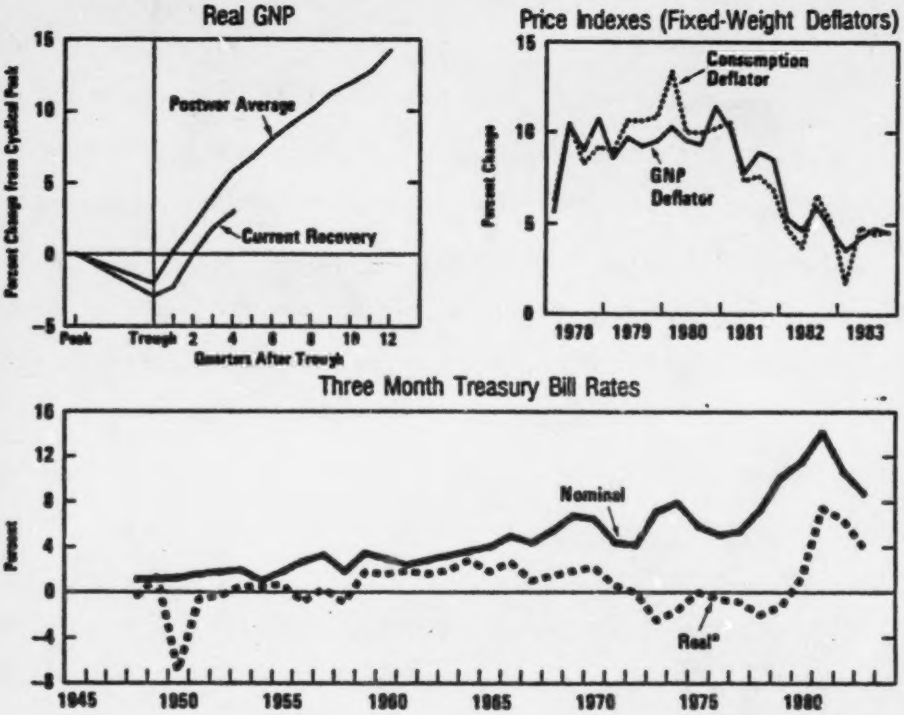
Inflation declined in 1983, though the rate of decline appeared to be slowing. The increase in the fixed-weight deflator, a broad measure of inflation, fell from a record 9.8 percent in calendar year 1980 to 6.4 percent in 1982 and to 4.3 percent in 1983. Although some of the decline in 1983 reflected temporary factors, present indications are that inflation will be quite moderate again this year.

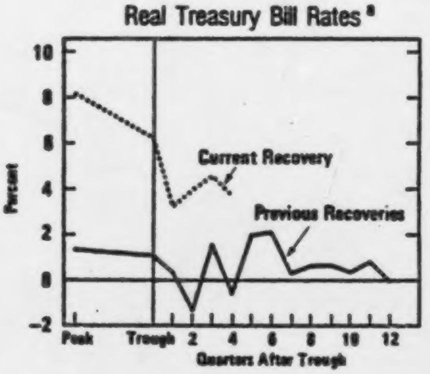
The Distribution of Growth

High interest rates, the most unusual feature of this recovery, have not had as large an effect on overall economic growth as many expected (see Figure 1). They have, however, affected the composition of growth. Net exports have been particularly hard hit. The U.S. merchandise trade balance ran a record $69 billion deficit in 1983, and some forecasters expect it to exceed $100 billion this year. At the same time, capital inflows were very strong because relatively high interest rates in the United States attracted foreign investors. Of course, the capital inflows benefited domestic investments and prevented interest rates from rising further. But, at the same time, foreign demand for dollars to invest in the United States pushed up the international exchange rate of the dollar to record levels. This in turn reduced foreign demand for the products of U.S. exporters, while cheaper imports reduced demand in many domestic industries. Thus,

Figure 1.

Recent Economic Developments





SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board; Congressional Budget Office.

*Unless otherwise specified real interest rates in this report are calculated by subtracting from the nominal interest rate the rate of inflation in the succeeding quarter. This value, the "ex post real rate," is a proxy for the unobserved real rate, which is the nominal rate less *expected* inflation over the life of the instrument. The inflation rate used for these two figures is that of the consumption deflator (fixed weight since 1958).

in 1983, net exports were effectively crowded out by tight credit conditions that arose, at least in part, from large budget deficits.

Interest rates also appear to be having an adverse effect on the recovery in residential construction, which at first was rapid. Between May and August of 1983, interest rates rose significantly, apparently because of strong economic growth and a tightening of monetary policy, and have since remained in a higher range than before. As a result, the growth in housing starts stalled in the fall and residential construction activity declined in the final quarter of 1983. The outlook for further growth in this sector now depends critically on the future course of interest rates and the resolution of the budget deficit problem.

THE CBO ECONOMIC PROJECTIONS

The CBO baseline economic projections, which are used to generate baseline budget estimates, consist of two parts: (1) a short-run forecast for the 1984-1985 period conditional upon specific policy assumptions; and (2) longer-run projections based upon historical growth trends and the assumption that inflation will gradually decline.

The Short-Run Forecast

The short-run baseline forecast incorporates the following policy assumptions:

- The federal budget policies are those currently in place. Defense authority, in real terms, increases at roughly a 5 percent rate. Budget outlays are $853 billion in fiscal year 1984 and $928 billion in fiscal year 1985.

TABLE 2. THE CBO FORECAST FOR 1984 AND 1985

Economic Variable	Actual		Forecast	
	1982	1983	1984	1985
Fourth Quarter to Fourth Quarter (percent change)				
Nominal GNP	2.6	10.4	10.3	9.0
Real GNP	-1.7	6.1	4.7	3.7
GNP Implicit Price Deflator	4.4	4.1	5.3	5.1
Consumer Price Index for Urban Consumers	4.5	3.3	5.1	4.9
Calendar Year Average (percent)				
Civilian Unemployment Rate	9.7	9.6	7.8	7.3
3-Month Treasury Bill Rate	10.6	8.6	8.9	8.6

- Federal government revenues are those associated with current law: $663 billion in fiscal year 1984 and $733 billion in 1985.
- Growth in the M1 money aggregate is assumed to be 6.0 percent over the four quarters of 1984 and 5.5 percent during 1985.

The forecast also assumes that there will be no price shocks or credit crises. Retail food prices are assumed to increase at about 4 percent in 1984 and 5 percent in 1985--reflecting the delayed effects of last summer's drought. Crude oil prices are assumed to remain constant, at about $29 per barrel, throughout the forecast period.

With these assumptions, real GNP is projected to rise 4.7 percent over the four quarters of 1984 and 3.7 percent during 1985 (see Table 2).

Average growth over the two years is slightly above the average for the second and third years of previous postwar recoveries. The civilian unemployment rate is projected to decline from 8.5 percent in the last quarter of 1983 to 7.6 percent by the end of 1984 and to 7.1 percent by late 1985.

As measured by the GNP deflator, inflation is expected to accelerate slightly from 4.2 percent in 1983 to 5.3 percent over the four quarters of 1984 and to average 5.1 percent during 1985. This increase in inflation reflects temporary factors--for example, the decline in oil prices last year that is not expected to be repeated this year, and a temporary acceleration in food prices later in 1984 stemming from last year's drought. In addition, the relatively rapid reduction of slack in the economy will tend to keep inflation from falling rapidly. However, nothing in the CBO forecast is inconsistent with the hypothesis that inflation is on a long-term downward trend.

The three-month Treasury bill rate is projected to average 8.9 percent this calendar year and slightly lower next year. Interest rates remain very high in real terms because of the exceptionally large amount of Treasury borrowing combined with strengthened private credit demands.

The Longer-Run Economic Projections

The baseline economic projections for the 1986-1989 period assume moderate noncyclical growth in output averaging about 3.4 percent per year (see Table 3). The projections for the long run are based on historical trends and are not meant to be necessarily consistent with the policies now in

TABLE 3. LONG-RUN ECONOMIC PROJECTIONS, CALENDAR YEARS 1984-1989

Economic Variable	1983 Actual	1984	1985	1986	1987	1988	1989
GNP (billions of current dollars)	3,310	3,651	3,995	4,339	4,704	5,084	5,481
Nominal GNP Growth Rate (percent change, year over year)	7.7	10.3	9.4	8.6	8.4	8.1	7.8
Real GNP (percent change, year over year)	3.3	5.4	4.1	3.5	3.5	3.4	3.3
GNP Implicit Price Deflator (percent change, year over year)	4.2	4.7	5.1	4.9	4.7	4.5	4.3
Consumer Price Index, CPI-U (percent change, year over year)	3.2	4.8	5.1	4.9	4.7	4.5	4.3
Civilian Unemployment Rate (percent, annual average)	9.6	7.8	7.3	7.0	6.8	6.6	6.5
3-Month Treasury Bill Rate (percent, annual average)	8.6	8.9	8.6	8.4	8.2	8.0	7.8

place. Unemployment declines gradually to 6.5 percent by the last year of the projection. Inflation declines very gradually from 5.1 percent in calendar year 1985 to 4.3 percent in 1989, and interest rates decline with inflation. This may be somewhat optimistic since analysis based on past experience suggests that the inflation rate might cease its decline given the assumed reduction in the unemployment rate. However, the relationship between unemployment and inflation is highly unstable and it is our judgment that if unemployment falls smoothly and slowly--as is implied by our growth path--continued progress can be made against inflation.

Since the longer-term projection of real growth is based upon historical trends, it is not intended to be an implicit judgment about what would be appropriate growth. 3/ For the seven-year period beginning with the recession trough (1982:4 to 1989:4), growth in real GNP averages 4 percent in the CBO baseline projection, precisely the same as the average growth rate during the first seven years following previous postwar recessions.

Uncertainty in the Outlook

There is a great deal of uncertainty in the economic outlook, particularly with respect to inflation and interest rates.

3/ Although these longer-run projections for inflation and nominal GNP growth do not reflect specified goals for the economy, they appear to be broadly consistent with statements by both the Administration and monetary authorities. See Economic Report of the President (February 1983), p. 23, and Paul A. Volcker, "We Can Survive Prosperity," an address to the American Economic Association, December 18, 1983.

- Inflation is subject to unforeseeable events—a bad crop year, a cut in oil supplies, or a sharp change in the value of the dollar in international exchange markets. Some analysts claim the dollar is "overvalued" by 20 percent or more; a decline in the dollar by that amount would raise the cost of imported goods and raise domestic prices by, perhaps, 2 percent. Inflation is also affected to an uncertain degree by the relative effects of economic slack and rapid growth.

- Interest rates are very difficult to forecast accurately. In addition to economic policy, the interest rate outlook depends on: the course of expected inflation, the response of savings to recent tax law changes, foreign capital inflows, and the risk of credit market disruptions, perhaps resulting from payment problems in developing countries.

The major source of uncertainty lies in economic policy. Some analysts believe that monetary policy has been too tight since last summer, and fear that there will be a slowdown in economic growth during the first half of this year despite the fiscal stimulus. Others are concerned that the Federal Reserve will find it difficult to maintain moderate money growth in the face of large federal deficits and the developing-country debt crisis.

With regard to fiscal policy, the major question is whether deficits will be reduced soon and if so, how? It is difficult for businesses and individuals to make effective decisions about the future without knowing what deficit-reducing measures will be taken and the impact these measures are likely to have on their activities. Moreover, the competition between private and federal credit demands will be intense, if policies are not changed. Federal borrowing will decline relative to GNP only in the first years of the projection--and then only slightly--and will remain exceptionally high and increase relative to GNP in later years.

If action on the deficit is postponed, it is also possible that foreigners will lose confidence in U.S. policies and reduce their investments in this country. While the resulting decline in the exchange value of the dollar would benefit U.S. export and import-competing industries, it would also generate increased domestic inflation and--given a fixed rate of money growth--push up interest rates. It may even force the Federal Reserve to undertake a more restrictive policy in order to maintain stability in foreign exchange markets.

THE BUDGET OUTLOOK

Given baseline economic assumptions and no change in the budget policies now in place, CBO estimates that the federal deficit will rise from about $190 billion this year to $326 billion in fiscal year 1989 (see Table 4). Despite rapid growth in GNP, the budget deficit rises from 5.3 percent of GNP in fiscal year 1984 to 6.1 percent in 1989, matching the record level established last year. Federal spending remains very strong in the baseline projection: relative to GNP, it declines from 24.7 percent in fiscal year 1983 (a postwar record) to 23.9 percent this year, but then rises to a new record high by 1989. Revenues are projected to be 18.6 percent of GNP in fiscal year 1984, rising gradually to 19.0 percent in 1988.

CBO's baseline budget projections are designed to show what would happen to the federal budget if current policies were continued into the future. For revenues and for mandatory spending items, current policies are largely defined by the laws now in effect. For discretionary spending,

TABLE 4. BASELINE BUDGET PROJECTIONS (By fiscal year)

	1983 Actual	1984 Base	Projections				
			1985	1986	1987	1988	1989
			In Billions of Dollars				
Baseline with 5 Percent Real Growth in Defense Authority a/							
Revenues	601	663	733	795	863	945	1,016
Outlays	796	853	928	1,012	1,112	1,227	1,342
Deficit	195	190	195	217	248	282	326
Budget Authority	867	923	1,019	1,116	1,231	1,374	1,504
Baseline with No Real Growth in Defense Budget Authority							
Revenues	601	663	733	795	863	945	1,016
Outlays	796	853	923	998	1,083	1,177	1,265
Deficit	195	190	190	203	220	232	249
Budget Authority	867	923	1,005	1,090	1,183	1,299	1,395
			As a Percent of GNP				
Baseline with 5 Percent Real Growth in Defense Budget Authority a/							
Revenues	18.6	18.6	18.7	18.7	18.7	19.0	18.9
Outlays	24.7	23.9	23.7	23.8	24.1	24.6	24.9
Deficit	6.1	5.3	5.0	5.1	5.4	5.6	6.1
Baseline with No Real Growth in Defense Budget Authority							
Revenues	18.6	18.6	18.7	18.7	18.7	19.0	18.9
Outlays	24.7	23.9	23.6	23.5	23.5	23.6	23.5
Deficit	6.1	5.3	4.9	4.8	4.8	4.7	4.6
Reference: Gross National Product (In billions of dollars)	3,229	3,563	3,910	4,251	4,612	4,987	5,379

a/ Defense budget authority for 1985 and 1986 is assumed to be the amounts specified in the most recent Congressional budget resolution; defense budget authority for 1987-1989 is an estimate of the amounts required to achieve real increases of 5 percent per year.

however, the definition of current policy is not as clear, since appropriations are made for only one year at a time. The baseline projections for nondefense appropriations are generally based on fiscal year 1984 funding levels, with future increases to keep pace with inflation. The projections for defense are based on the fiscal year 1984 Congressional budget resolution, which not only allowed defense spending to keep pace with inflation but also provided for roughly 5 percent annual real growth in defense budget authority.

While our baseline projections assume 5 percent real growth in defense spending as the best approximation of current policy, CBO has also projected defense expenditures on the same basis as is used for nondefense discretionary programs. These alternative defense projections simply increase 1984 defense budget authority by the rate of inflation and thus allow for no real growth in defense spending. Even with no real defense growth, however, the deficit would still reach $249 billion by 1989 (see Table 4).

Changes in the Composition of Revenues and Spending

The composition of federal revenues is projected to change somewhat over the next five years. Individual income taxes and social insurance taxes rise faster than other taxes, growing from 80 percent of total revenues in 1984 to 85 percent by 1989. Corporate income taxes, excise taxes, and other receipts will continue to diminish in relative importance (see Table 5).

TABLE 5. BASELINE REVENUE AND OUTLAY PROJECTIONS BY SOURCE OR MAJOR CATEGORY (By fiscal year, in billions of dollars)

	1983 Actual	1984 Base	Projections				
			1985	1986	1987	1988	1989
Revenues							
Individual Income Taxes	289	294	329	362	396	438	478
Corporate Income Taxes	37	62	65	71	81	85	85
Social Insurance Taxes	209	237	269	296	320	354	382
Excise Taxes							
Windfall profit taxes	13	9	7	5	4	4	4
Other	22	29	31	27	28	28	29
Estate and Gift Taxes	6	6	6	5	5	4	5
Customs Duties	9	10	11	12	12	12	13
Miscellaneous Receipts	16	16	16	17	18	19	20
Total Baseline Revenues	601	663	733	795	863	945	1,016
Outlays							
National Defense	210	235	263	295	331	372	419
Entitlements and Other Mandatory Spending							
Social Security	165	173	184	197	211	227	243
Medicare	56	64	74	83	94	106	120
Other	179	162	167	177	186	197	208
Subtotal	400	400	425	456	490	530	570
Nondefense Discretionary Spending	144	156	161	168	178	189	198
Net Interest	90	108	127	145	168	194	219
Offsetting Receipts	-48	-46	-49	-52	-55	-59	-64
Total Baseline Outlays	796	853	928	1,012	1,112	1,227	1,342

Changes in the composition of federal spending are more substantial. The most rapidly growing category of spending in the baseline is net interest. With large and growing deficits and no reduction in inflation-adjusted interest rates after 1985, federal borrowing costs are projected to double over the next five years. The portion of gross spending (excluding offsetting receipts) devoted to interest rises from 12 percent in 1984 to 16 percent by 1989. Defense spending grows by 79 percent between 1984 and 1989, assuming real increases of 5 percent per year. The share of defense spending in the budget grows from 26 percent to 30 percent.

In our projections, domestic spending--the combination of entitlements and discretionary programs--grows by 38 percent between now and 1989. Because this is well below the rate of increase in total outlays, their share of the budget declines from 62 percent in 1984 to 55 percent in 1989. The dollar increase is still substantial, however, from $556 billion in 1984 to $769 billion in 1989. Of this $213 billion increase, $124 billion--or 58 percent--is in just two programs, Social Security and Medicare.

Perhaps the most important point to make about the spending side of the budget is that very few programs are responsible for the bulk of federal outlays. Our projections suggest that, by 1989, spending on defense, Social Security, Medicare, and net interest will be equivalent to almost 100 percent of total tax revenues.

Comparison of CBO and Administration Economic Assumptions and Budget Projections

The CBO and Administration economic forecasts for 1984 and 1985 are very similar (see Table 6). Projected growth rates for real GNP are almost identical. The Administration's short-run forecast for inflation is only slightly more optimistic. Interest rates are lower in the Administration's forecast, but by less than one percentage point.

However, the Administration's longer-run projections for the 1986-1989 period are considerably more optimistic than CBO's. The Administration's projection shows growth rates averaging about one half of one percentage point higher than CBO's, and inflation lower by a similar amount. However, the largest difference between the CBO and Administration's projections is in the area of interest rates. The Administration's projections show substantially lower interest rates than CBO's, with the differential growing.

The Administration's budget estimates, presented in Table 7, show substantially lower outlays and somewhat higher revenues than CBO's baseline budget estimates. CBO is now examining the Administration's budget to determine how much of the differential is due to differences in policy assumptions and how much is due to differences in economic assumptions or technical estimating methods. While the analysis is not complete, it appears that economic assumptions account for a large part of the difference in budget estimates in the 1986-1989 period. Interest-rate

TABLE 6. COMPARISON OF CBO AND ADMINISTRATION'S ECONOMIC ASSUMPTIONS (By calendar year)

	1984	1985	1986	1987	1988	1989
GNP (billions of current dollars)						
CBO	3651.2	3994.8	4339.0	4703.7	5083.5	5480.5
Administration	3642.4	3973.8	4319.2	4681.2	5059.0	5444.9
Difference	8.8	21.0	19.8	22.5	24.5	35.6
Real GNP, (1972 dollars, percent change, year over year)						
CBO	5.4	4.1	3.5	3.5	3.4	3.3
Administration	5.3	4.1	4.0	4.0	4.0	3.9
Difference	0.1	0.0	-0.5	-0.5	-0.6	-0.6
GNP Deflators (percent change, year over year)						
CBO	4.7	5.1	4.9	4.7	4.5	4.3
Administration	4.5	4.8	4.5	4.2	3.9	3.6
Difference	0.2	0.3	0.4	0.5	0.6	0.7
Consumer Price Index (percent change, year over year) a/						
CBO	4.5	5.0	4.9	4.7	4.5	4.3
Administration	4.4	4.6	4.5	4.2	3.9	3.6
Difference	0.2	0.4	0.4	0.5	0.6	0.7
Civilian Unemployment Rate (percent, annual average)						
CBO	7.8	7.3	7.0	6.8	6.6	6.5
Administration b/	7.9	7.7	7.5	6.9	6.2	5.8
Difference	-0.1	-0.4	-0.5	-0.1	0.4	0.7
90-Day Treasury Bills (percent, annual average)						
CBO	8.9	8.6	8.4	8.2	8.0	7.8
Administration	8.5	7.7	7.1	6.2	5.5	5.0
Difference	0.4	0.9	1.3	2.0	2.5	2.8

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a/ Consumer price index for urban wage earners and clerical workers.

b/ The Administration publishes only the overall unemployment rate. The adjustment to civilian is made by CBO.

TABLE 7. ADMINISTRATION UNIFIED BUDGET ESTIMATES (By fiscal year, in billions of dollars)

	1983 Actual	1984	1985	1986	1987	1988	1989
Revenues	601	670	745	815	888	978	1060
Outlays	796	854	925	992	1068	1130	1184
Deficit	195	184	180	177	180	152	123

projections appear to account for about half ($80 billion) of the differences between the CBO and Administration outlay estimates in fiscal year 1989. The Administration's current services revenue estimates are above those of CBO, though the Administration, for the most part, assumes lower incomes. We will have a report on the Administration's budget in a few weeks when our analysis is complete.

The analysis produced by both the Administration and CBO shows that it is unlikely that a vigorous economic expansion will cure the deficit problem. The Adminstration's current services budget shows persistent deficits of around $200 billion annually in the projection period. CBO's analysis indicates that, even if economic growth matches the strong expansion of the 1960s, which appears unlikely, federal deficits will probably remain at near-record levels unless policies are changed. 4/ The sheer magnitude of the projected budget deficits means that percentage errors in forecasting them are likely to be much smaller than in the past. 5/ It is noteworthy that CBO's projection of the deficit for fiscal year 1988 has changed very little from that of a year ago. 6/

CONSEQUENCES OF LARGE DEFICITS

Federal deficits of the magnitude shown in the baseline projection would have major consequences both for the economy and for future budgetary choices. Most economists agree that federal deficits of the size projected by CBO keep interest rates higher than they would be otherwise. The effect would be particularly strong as the economy approached full employment (or the limits to growth set by monetary policy), where public and private borrowing would compete for a relatively fixed level of saving.

4/ Congressional Budget Office, The Economic Outlook (February 1984). See CBO's high-growth path and associated budget estimates in Chapter I.

5/ Forecasts of deficits have shown large errors in the past because the deficits were a residual of two much larger numbers. Thus in the 1960s, when deficits averaged 4.6 percent of total outlays, a 5 percent error in the forecast of spending would have resulted in a 109 percent error in the projected deficit. But in 1983, when the deficit was 24.6 percent of outlays, a 5 percent error in the outlay estimate would have resulted in an error of only 20 percent in the deficit estimate, other things being equal.

6/ CBO currently projects a fiscal year 1988 baseline budget deficit of $282 billion, up from the $267 billion in CBO's February 1983 baseline budget projection for fiscal year 1988.

Even in the present situation of less than full employment, deficits are likely to raise interest rates. A few analysts contend that there is no historical evidence for a link between deficits and interest rates. But one should not expect to find in historical data a simple association between deficits and interest rates. Previous deficits experienced during peacetime have been much smaller than those now projected, and their impact on interest rates has often been overwhelmed by recessions, Federal Reserve policies, or international capital flows.

The current and prospective deficits are extremely large relative to past history. In fiscal year 1983, the federal deficit was about 107 percent of domestic net private saving and 34 percent of gross private saving. Our forecast implies that federal deficits would be 79 percent of net private savings and 29 percent of gross private savings during the fiscal year 1984-1985 period. Fortunately, very large capital inflows from abroad have so far limited the rise in interest rates. It should be emphasized that these capital inflows are not a costless remedy for deficits. If the capital inflow continued for a long time, foreign claims on U.S. output could rise to such a level that it would reduce our standard of living significantly below what it would be if we decreased government borrowing and relied less on capital inflows.

High interest rates, if they persist, are likely to reduce capital accumulation. Although the cyclical rise in demands and increased capacity utilization rates are now providing a strong stimulus to investment, this may eventually be offset by the retarding effect of high interest rates on structures investment. Over time a reduction in the capital-output ratio will retard growth in productivity, the major source of rising living standards.

The Interest Payment Bill

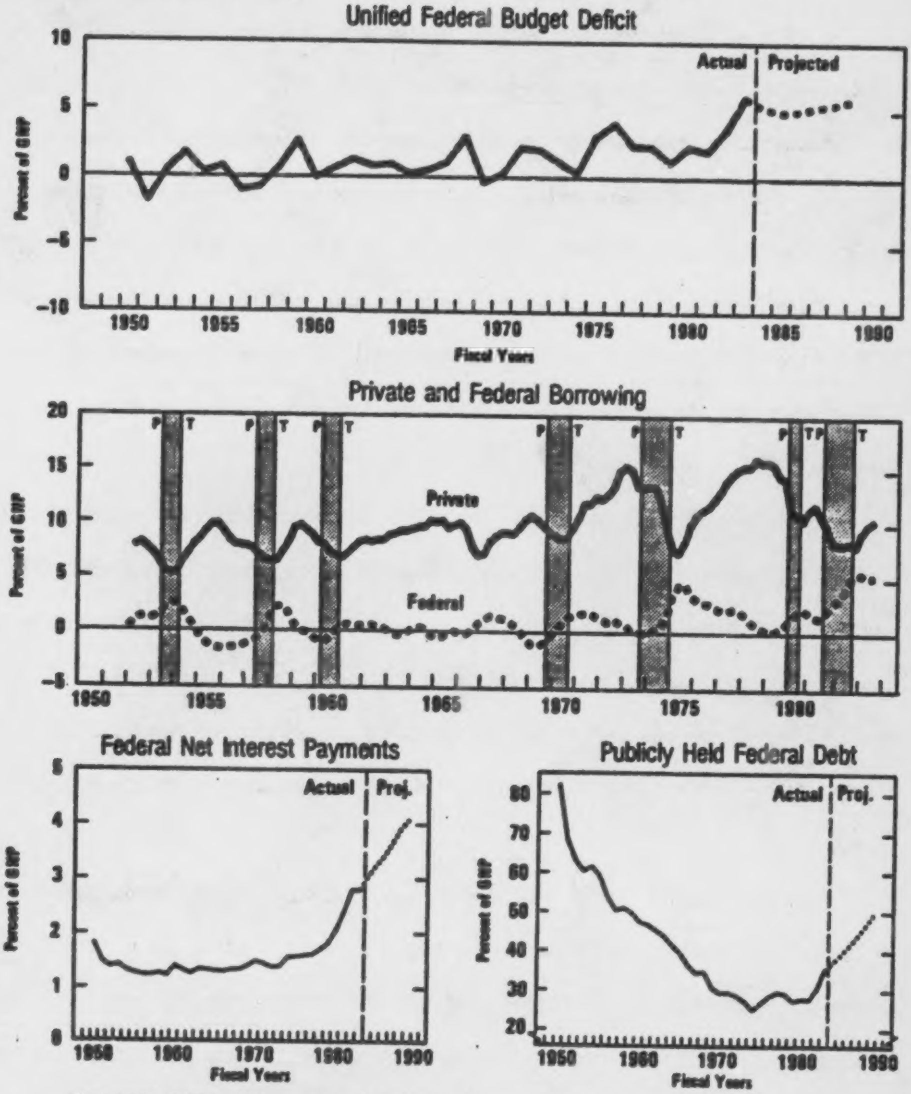
The most striking feature of the CBO budget baseline projections is the extremely rapid growth in outlays for interest on the debt (see Figure 2). Net interest costs, which were between 1 and 2 percent of GNP for decades, are projected to rise from 2.8 percent of GNP in fiscal year 1983 to 4.1 percent in 1989. In these circumstances, major spending cuts or tax increases are necessary just to avoid the possibility of explosive growth in interest outlays.

The rapid rise in the debt-to-GNP ratio also makes the future deficit outlook highly sensitive to interest rates, one of the hardest economic variables to forecast. A one-percentage-point error in the forecast, if continued through the projection period, implies a $30 billion error in the projection of the 1989 deficit.

REDUCING THE DEFICIT

I am pleased to be releasing today before this Committee part III of CBO's annual report on options for reducing the deficit. This is the fifth in a series of studies that presents options--not recommendations--for cutting spending or raising taxes. There is no really adequate way to summarize the approximately 138 options (98 in spending and 40 in revenues) presented, but

Figure 2.
Government Borrowing



Unified Federal Budget Deficit

Private and Federal Borrowing

Federal Net Interest Payments

Publicly Held Federal Debt

SOURCES: Office of Management and Budget; U.S. Department of Commerce, Bureau of Economic analysis; Congressional Budget Office.

NOTE: P and T lines indicate business cycle peak and trough dates.

perhaps I can give some flavor of the analysis by culling one highlight from each substantive chapter.

In national defense, the options discussed contrast the difficult trade-off between short term readiness efforts and long-term buildup of conventional and nuclear weapons systems, with the sobering conclusion that to bring the Administration's defense budget down to 5 percent real growth--the rate incorporated in last year's budget resolution--will require $174 billion in cuts from defense budget authority between 1985 and 1989 (using the Administration's defense price assumptions). To freeze defense budget authority at the 1984 level--adjusting only for inflation--will take cuts of over $400 billion in the next five years.

In Medicare and Medicaid, the CBO analysts illustrate each of the variety of ways that federal costs can be held down: by restraining payments to hospitals and doctors, by making patients or taxpayers pay more, or by shifting more of the costs to state and local government. A key factor in cost control and in the solvency of the Medicare program will be how well the new prospective payment system works. It is much too early to tell.

Social Security and other entitlements (including agricultural price supports) are such a large part of budget outlays that a wide variety of proposals is already on the table. Our options cover limits on cost-of-living adjustments (COLAs), reductions in eligibility for some entitlements, restraints on federal employee retirement, and significant reductions in crop price supports.

The remainder of the noninterest budget--nondefense discretionary programs--is made up of hundreds of relatively small accounts. Correspondingly, each option discussed in this section of our study yields relatively small budgetary savings. To close a substantial fraction of the deficit from cuts in these programs would require moving on many fronts at one time.

Our study concludes with a discussion of revenue-raising options. Here we have made a distinction between relatively small, specific changes in the tax code that even if packaged together would raise only relatively small sums (these are listed as options starting on page 199) and the bigger steps that could be taken to modify our tax system to raise yields. These latter--including major base-broadening, surtaxes, dropping indexing, and consumption taxes--are discussed in the body of Chapter VI of our volume.

The analysis clearly brings out the difficulty of resolving the budget dilemma. The fact is that all spending does some good for someone and all taxes do some harm to someone, so there is never a good spending cut or tax increase in the eyes of the entire electorate. Nonetheless, our budgetary predicament requires that we make difficult choices and search for the least damaging package of deficit reduction options that can command majority support. I hope our discussion helps this search.

HOLDING THE DEBT-TO-GNP RATIO CONSTANT

Chairman DOMENICI. Staff tells me, Dr. Penner, that yesterday before the House committee, you mentioned the goal of holding the debt-to-GNP ratio constant.

Dr. PENNER. Yes.

Chairman DOMENICI. Could you tell us quickly what that means in terms of the current situation and what amount of deficit reduction would be required to do that and to hold the ratio there?

Dr. PENNER. Let me first mention why one might want to have that standard. If interest rates remain constant over a long time, then obviously, if you hold the total debt-to-GNP ratio constant, your interest bill will stabilize relative to GNP and relative to your total tax base. Now, of course, the growing interest bill in this budget is of grave concern. So that is why you might want to hold the ratio constant—and eventually, one hopes, reduce it—if we could ever get it constant first.

To achieve that level, however, requires a major deficit reduction. Indeed, according to our projections, we would have to lower the annual deficit by $110 billion by 1987.

Chairman DOMENICI. The 1987 deficit would have to be reduced by $110 billion?

Dr. PENNER. That is right.

Chairman DOMENICI. That would be from the number you have got?

Dr. PENNER. That is right.

Chairman DOMENICI. Can you give us some estimate of how much would be required in 1985?

Dr. PENNER. Yes. We will provide that for the record.

[The following was subsequently supplied for the record:]

The deficit reduction that would be required in fiscal year 1985 to hold the debt-to-GNP ratio constant is $78 billion.

Chairman DOMENICI. All right.

Dr. PENNER. But it would be the same order of magnitude, I believe, Mr. Chairman.

Chairman DOMENICI. So if it is $110 billion, comparatively speaking, what is your deficit in 1987?

Dr. PENNER. We will provide that for the record, too, if we may.

Chairman DOMENICI. Would you get it for us?

Dr. PENNER. Yes, certainly, and what was your next question, sir?

[The following was subsequently supplied for the record:]

A $110 billion cut would reduce the 1987 deficit from our baseline projection of $248 billion to $138 billion.

GROWTH COULD HAVE BEEN HIGHER WITH LOWER DEFICITS

Chairman DOMENICI. Well, I was just going to put $110 billion and use a fraction of what the deficit would be in 1987 and have a percent, but I would rather that it be right, so you can just give it to us.

Would economic growth have been higher during the past year if the deficits were lower?

Dr. **Penner**. That is a very difficult question to answer, sir. The way we approach that question, we do still think that, on balance, deficits are expansionary, as in traditional Keynesian theory—though not as expansionary as extreme Keynesians might have it. The reason is simply that, in this world of flexible exchange rates and perfectly operating international capital markets, a deficit tends to raise interest rates, attract foreign capital, and raise the value of your currency. And then, of course, you get an offset in a deteriorating trade balance. But the simple answer to your question is probably yes, but probably not much. And the other crucial component is that I am assuming no change in monetary policy. It is quite conceivable that, if you had had a lower deficit, the monetary authorities might have felt it less risky to be a bit easier with monetary policy.

Chairman **Domenici**. But, basically, if I get the tenor of your report which has only been summarized to me—and you have, in turn summarized it—you are really warning us about the 1985, 1986, 1987, 1988, and 1989 timeframe as it might affect or abort the recovery which, on historic standards, is rather good at this point. Is that what you are telling us?

Dr. **Penner**. That is basically the message surrounding our best guess of the future. We say that that guess has to be made with considerable uncertainty under current circumstances, because we are dealing here with a deficit that is really outside the bounds of historical experience. For all we know, it might work differently this time from how it has in the past, but our best guess is that the expansion can continue. The real harm done by this deficit is to long-term future economic growth; by lowering the standard of living associated with full employment in future years.

There is another important danger in the long term, and that is that the pressures of ever-growing deficits may ultimately push us toward deciding that inflation is the easiest way out of this dilemma. Again, that is a long-term threat.

Chairman **Domenici**. You summarized the level of budgetary expenditures versus the revenue estimates, and you indicated that defense, interest on the debt, social security, and medicare equal the revenues.

Dr. **Penner**. In 1989, yes.

RISKS IN BRINGING DEFICITS DOWN TOO FAST

Chairman **Domenici**. For now, we are very close; we have to add a couple of things, but we are almost there. We are fairly close at this point.

I assume you would agree that there are some risks involved in bringing the deficit down too fast. We would have to draw the line there and abolish all the rest of the programs of Government to pick up the $190 billion. You would not recommend that, would you? Not that we could do it, but there are some who say do it all on the expenditure side.

Dr. **Penner**. I guess it is not something I spend a lot of time worrying about, Mr. Chairman. But in theory, yes, you could bring it down too fast. But as I say, that worry does not keep me up nights right now.

Chairman **Domenici**. You have not seen any evidence that we are intent on doing that?

Dr. **Penner**. No.

Mr. Chairman, I did get the number. If you want to stabilize the debt-to-GNP ratio in 1985—that is, at the 1984 level—it would require a little less deficit reduction than I thought, namely, $78 billion in 1985.

Chairman **Domenici**. Senator Chiles?

INCREASE IN REVENUES WOULD BE NECESSARY

Senator **Chiles**. Dr. Penner, on page 33 of the baseline projections volume, you make a concise statement of the problem. These large deficits come about from combining the outlay levels of the 1980's with the revenue levels of the 1960's and 1970's.

The administration points out that it wants to return defense spending to the share of GNP that it took in the 1960's. But, of course, we did not pass medicare until 1965, and since then we have had a tremendous growth in the older population eligible for the retirement program.

Does it not kind of add up to saying that we cannot return defense to a higher share of the GNP unless we either raise taxes or totally cut some of the social commitments, like medicare?

Yet, even the administration, of course, has not talked about totally eliminating medicare. Maybe that is one of their options after the election. But is there any way that we can return military to its 1960 share of the GNP without either doing something on the revenue side or cutting some of these programs we have started since the 1960's?

Dr. **Penner**. Given my rundown of the relative importance of defense, social security, and medicare, very obviously if we decide that we need the defense growth that is inherent in our baseline, it would certainly be very difficult to imagine altering the outlay side of that baseline really substantially without really altering social security and medicare in very important ways.

If you decided that you did not want to do that either, then—again, obviously—there is not a lot you could get out of the remaining side of the budget. So, under the circumstances as you have added them up, if you want to make progress on the deficit, an increase in revenues would be necessary.

ABRUPT EVENTS POSSIBLE

Senator **Chiles**. It seems to be your intuition that we will not have a collision; that this is going to be a gradual erosion. Is the gradual erosion, in your mind, as dangerous as the collision?

Dr. **Penner**. If one talked about a collision in the sense of there really being a violent event, it would have to be psychological, somehow or other—that is to say, there would have to be a quick change in mood. As I mentioned, one of the big risks is a quick change in the degree of confidence that foreign investors have in us. Now, they are helping us out greatly by providing all this capital to us. If they decided that we were not a good risk for one reason or another and withdrew, that would have severe consequences, especially if it happened over a very short period of time.

It would imply an immediate rise in interest rates in this country; a fall, perhaps rapid, in the exchange rate; therefore, pressures on our inflation rate, and so on. So I do not want to rule out the possibility of abrupt events.

Senator **Chiles**. I understand. You are saying that given the historical size of these deficits, there is no way; you are not sure, you are not certain.

Dr. **Penner**. That is the point I am trying to make.

Senator **Chiles**. I understand. The point I want to hear from you—and it is my feeling, based on your noncollision theory, that that is more dangerous than the collision theory.

Dr. **Penner**. I understand what you are saying.

EVERY SOLUTION HAS SOME PAIN

Senator **Chiles**. If the collision occurs and if the stock market continued to slide from where it is now—and we do not know why it is down at this point; some people say it is all the deficit, but we do not know.

But if it continued downward, if something happened in the bond market, if something happened to dramatically cause those interest rates to go down or, as you suggest if foreign investors started to pull back, then I think there would be a strong impetus on the Congress and the President to do something.

If it slides, which appears to be your intuition, and just keeps gradually sliding and sliding and sliding, the way it is now, the signals are cloudy. Part of the news looks good; unemployment is coming down, interest rates have not really jumped up yet.

These little things that worry us, like the housing slide could be much more dangerous because we will not come to grips with them.

Dr. **Penner**. I am afraid that is right, Senator. I did not understand your point before, but I would certainly agree with what you said, and that is exactly what makes it so difficult to solve the problem, as you are suggesting. Every solution, as we have said, has some pain that goes with it. That pain is very readily apparent. Whereas if the harm done by the deficit is gradual and barely noticeable over a very short time period, then of course, it is so much more difficult to persuade people to undergo the pain of doing something about it.

NO CREDIT CRUNCH FORESEEN

Senator **Chiles**. Well, I think it is important that we know your opinion on this matter. If there is no action on the deficit, will we have a credit crunch?

Dr. **Penner**. The way things are working, in our projections through 1985, the short-term deficit actually goes down relative to GNP, and as I noted, relative to national savings. Moreover, the rate of growth slows, so there is less growth in demand from the private sector in 1984 and 1985. So in our view of the economy, we do not forecast a major change in interest rates. We have them going up a little bit in nominal terms in 1984, and then sliding back a very little bit in 1985. But essentially, interest rates are stable throughout. So we do not foresee the kind of credit crunch that you are hinting at. But again, I return to the possibility of psychological factors.

NATION CAN LIVE WELL ON BORROWED MONEY

Senator **Chiles**. Well, you do not look further out there? In other words, I am not asking you to predict just when, but if we do not change our policies, what happens? You have already said if we do not make some changes this year, anything we do in 1985 does not take effect until late in 1986.

Dr. **Penner**. Another way of putting the problem, Senator, is that eventually, a nation—like a household—can live pretty well on borrowed money. We can live it up as long as people are willing to lend it to us. That could be a matter of 6 months; it could be a matter of 6 years. The point is that we are now borrowing at a rate such that our debt is going up much faster than our income. A banker looking at a household that is borrowing from him may tolerate that for a while. But there will come a day when they will say, "No more. We are just not going to lend you any more." That day is the day of your credit crunch. It is very hard to say when that comes.

I would like to define your notion of acting on the deficit a little more precisely. I think there are different ways of looking at this. I think that it is very important that discussion, at least, start quickly. This is a very complicated problem that we are facing. We have to start narrowing down the range of options, it seems to me. It is very important, I think, when we do act, to make fundamental changes.

Now, we have a situation in our projections where the outlay line is running up that way; the revenue line is running down that way. You have this widening gap. What we have got to do is tilt those two lines so they start to converge out there somewhere that we can see. That does not mean that the deficit has to come down in 1985 all that much, but it does mean, in my view, that there should be prospects that start to show progress over the long run—prospects that markets can count on and that taxpayers can count on and recipients of benefits can count on. That is the most important thing to do here, but again let me repeat: I think it a complicated enough task that you have got to start working on it right away.

ACTION MUST BE TAKEN

Senator **Chiles**. Let me ask you to explain what policies you think we have to initiate now to achieve the CBO economic assumptions. I realize that the economic assumptions CBO used for its baseline predictions are based on historical trends for the outlay years 1986 through 1989.

It would be helpful for us to know what macroeconomic policies are consistent with those assumptions. In other words, what economic policies do we need to initiate now so that the CBO assumptions of a 3.5-percent average real growth and 4.5 percent inflation are achievable goals?

Can we do absolutely nothing or is there something that we need now to do to achieve that?

Dr. **Penner**. When you look that far in the future, of course, Senator, any statement that one makes has to be put forward very tentatively. It is conceivable that, even with current policies, you could achieve that path. What would be required is extraordinary confidence on the part of the foreigners who would have to lend us money in huge amounts to keep us going along that path—a situation that I would consider to be very, very unlikely. My judgment is that that just would not happen for that long a period.

Senator **Chiles**. So, it is your judgment it would not happen?

Dr. **Penner**. It would not happen. To make this work when we do these projections, we have got to make everything add up. Frankly, what we put in there to make it add up was, among other things, a lot of foreign borrowing.

But I think we have to move pretty close toward the situation where we will start stabilizing that debt-to-GNP ratio. We do not have to get all the way there, but I would think that you would have to get close enough. Again, I think so much of this is psychological that you would have to get close enough that people felt confident that you were attaining what I would call a modest goal within a relatively short period of time.

Senator **Chiles**. Well, the point I am trying to make basically, is that CBO has made some economic assumptions in order to prove out the rest of those numbers.

Dr. **Penner**. Yes.

Senator **Chiles**. And those assumptions are showing, historically, a good growth rate; historically, a very good inflation rate; historically, a very declining unemployment rate. And for all of those things to happen, there almost would have to be something else happening in regard to our fiscal and monetary policy to accommodate those, so you can make your other assumptions.

Dr. **Penner**. Yes.

Senator **Chiles**. You probably cannot get there from here unless we take some action. So, in other words, we would not get to that 6.5 unemployment rate, or we would not get the kind of interest rate, or we would not get the kind of growth rate if we just continue along that course. Would you agree with that?

Dr. **Penner**. That would certainly be my judgment, sir. I cannot say it absolutely, certainly cannot happen, but it would not be my judgment that it would.

Senator **Chiles**. But you are not confident at all, and you are not trying to base your report on the fact that this will happen; that we can just let the thing go the way it is going and get all of those features?

Dr. **Penner**. Absolutely not, no.

Senator **Chiles**. Those are sort of control features that are put in so that we can project the rest of the numbers?

Dr. **Penner**. That is correct.

Senator **Chiles**. That is all I have.

STABILIZING RATIO OF DEBT TO GNP REQUIRES SACRIFICE

Chairman **Domenici**. I am going to, Dr. Penner, have to leave for another hearing for a minute, and Senator Quayle is going to preside. Let me just take this one assumption on my part.

Actually, what Senator Chiles has been talking about in terms of the outyears and what you have been describing as a multiyear, long-term problem, I think, is tremendously complicated by the electorate because at this particular point in time—and we certainly do not want to change this dramatically—people are very upbeat, optimistic.

Those things they feel around the breakfast table or around the dinner table some evening, talking with the family about decisions—those things are all better than they were, and this deficit that we see is a theoretical thing. But it appears to me that about the time the electorate decides that we must give all of these leaders the latitude to do something, and we will sacrifice, we will be in a recession and then we will not be able to do it.

These deficits you predict here are not predicated upon any downturn. You have got constant positives, although not as much as some theoreticians think will happen. I tend to think you are right; it is going to be very steady and as you have described it, more or less.

I think that is the dilemma we are in at this point. You will not get this ratio stabilized, if that is the goal, and that is a very nice way of putting it. I am intrigued by the idea of stabilizing the ratio of debt to GNP.

1 PERCENT OF GNP IS $40 BILLION

You will not get that without some sacrifice. Although it sounds like a simple proposition, it is a lot. So, for this record and for those who are not involved in budgeting, where Dr. Penner has referred to 1 percent of GNP, that is how many billion, more or less?

Dr. **Penner**. In what year?

Chairman **Domenici**. Let us take 1985 first.

Dr. **Penner**. Let me give you the exact number here. For the fiscal year, I was going to say $40 billion; I should have because it is $39.95 billion.

Chairman **Domenici**. So, for those who are listening to the testimony and wondering every time we mention GNP, 1 percent of GNP, ballpark number, is $40 billion. So, when we mention 3 percent of GNP, we are talking about $120 billion, plus or minus.

I am going to yield now to the Senator from Indiana, and thank you very much, Dr. Penner.

Dr. **Penner**. It might be useful, Mr. Chairman, for me to elaborate on the $110 billion figure I gave you for 1987. It should be noted in all of this that while, on the one hand, it is the interest bill that is giving us enormous problems and feeding the growth of the deficit, that problem cuts two ways; that is to say, any moneys you save have an interest multiplier attached to them which is really very substantial.

Moreover, if it can be argued, and I would, that if you make progress, you can hope for lower interest rates, then you get a double kind of interest multiplier. So the $110 billion need not mean $110 billion in program cuts or in real tax increases.

Chairman **Domenici**. And you also minimize that risk you have described about outside capital, which is not necessarily measurable yet.

Dr. **Penner**. That is right.

Chairman **Domenici**. But you say it will be measurable over the long haul in that it would reduce our standard of living?

Dr. **Penner**. Yes.

Chairman **Domenici**. Senator Hatch asked that a statement be made part of the record, and it will be, without objection.

[The prepared statement of Senator Hatch follows:]

Statement of Senator Hatch

Mr. Penner, I join my colleagues in welcoming your appearance before the Budget Committee. We all look forward to cooperating to assure our country's continued economic recovery.

To that purpose, having looked at the documents—The Economic Outlook and Budget Projections—released by CBO yesterday, I have two matters I would like to discuss with you. The first is deficits. The second is the economic assumptions used in making your budget projections.

First, there is unanimity in decrying our large budget deficits. I, too, decry these deficits. But I believe that the emphasis placed on the deficits themselves as the certain direct cause of an economic downturn is a misplaced emphasis. Deficits only indirectly reflect federal spending: the size of the deficit simply tells us how Congress and the Administration have chosen to fund federal spending, whether by borrowing or by taxation.

Federal spending itself should be the cause of concern of those who decry deficits, for the level of federal spending is the real barometer of our economic health because it is the best measure of the fiscal disincentives imposed on the private sector. By either raising taxes or borrowing funds to support spending, the Government increases the price of labor and capital needed for our economic machine. Increased taxes discourage work and investment. So does increased borrowing, through interest-rate increases which raise the cost of borrowing for both investment and consumption. That is, either taxing or borrowing to fund federal spending takes resources out of the economy, resources that could be used to purchase goods and services and to create jobs.

It has become increasingly popular to claim that the 1981 tax cuts are the cause of today's large deficits. This falsehood is laid to rest by looking at federal revenues and spending as a percentage of national income, and illustrates the increasing burden of federal financing. In 1973, revenues were 23.8 percent; but, in 1983, they had increased—up to 24.3 percent. In contrast, in 1973, federal spending amounted to 24.3 percent of national income; but, in 1983, it surged to 31.2 percent, a 6-point increase. The message is clear. Deficits are not the result of a lack of revenue. Excessive federal spending is to blame.

Thus, I suggest that we must reexamine and reorder our national priorities to bring federal spending into line with these priorities and to reduce its levels altogether. Unfortunately, we really do not have the choice that some of my colleagues suggest of raising taxes as well as reducing spending somewhat in order to reduce the deficit. Taxing is as harmful in its own way as borrowing. To reduce the deficit, we must get federal spending under control—period.

Second, I am concerned about the accuracy of budget forecasts, particularly when for the last several months the growth in the money supply has been so tight. I note that in CBO's documents released yesterday you often mention those economists who warn we could have rekindled inflation in late 1984 because of the great surge in the money supply from July of 1982 to July of 1983 and who also warn of a possible recession in the first half of 1984 due to the greatly restricted growth in the money supply since mid 1983. However, in neither your baseline nor your alternative economic assumptions do you account for the effects if these events occur. I am deeply concerned about what their result would be for the deficit, or even what only a 1 percent lower growth rate would mean for our economy and deficits.

Let me say in conclusion that I hope that the massive attention currently focusing on deficits will force us to reexamine and reorder our national priorities in order to reduce federal spending and to realize the wisdom of a slow and steady moderate growth in the money supply.

[Senator Quayle assumed the Chair.]

Senator **Quayle**. We will proceed under our early bird rule because Senator Gorton will not let us proceed any other way, so I will call on Senator Gorton at this time.

Senator **Gorton**. Thank you, Mr. Chairman. I must say that I find this newest concept of not letting these ratios get any worse to be an intriguing one, Dr. Penner. We have long since stopped talking realistically about getting to a point at which expenditures and revenues are in balance.

Perhaps this is a more realistic goal. I hope that it is more easily attainable than the other. I do understand that Senator Quayle wants to ask you a number of questions on that, so I am going to go from these highly general questions to a very specific one on an alternative which is included in your new volume III, and one which greatly bothers me in my capacity of representing people from a given State.

It is the example of possible revenue increases which is found on page 209.

ELIMINATING THE DEDUCTIBILITY OF STATE AND LOCAL SALES TAXES

It is the alternative of eliminating the deductibility of State and local sales taxes. You know, I have been troubled for the more than 3 years I have been a member that that alternative constantly appears in proposals for revenue increases in precisely that form, rather than in the form of eliminating the deductibility of State and local taxes in general or the deductibility of the primary State and local tax in any given jurisdiction.

I believe that with the single exception of New Hampshire every State in the United States has as its primary source of revenue either a personal income tax or a sales tax. The majority of the States have both, but some depend more heavily on one than on the other.

The two adjoining States in the Pacific Northwest are perhaps the two extremes or types of the two extremes. The State of Washington has no personal income tax and a very high sales tax. The State of Oregon has no sales tax and a very high progressive income tax.

Roughly speaking each of those taxes brings in the same share of revenue for the State as does the other.

My question to you is: What possible justification can there be for the Federal Government to make a choice which is so punitive against the citizens of one State, which has no impact at all on the citizens of another State? How can we justify a choice which will impose much higher Federal taxes on citizens of the State of Washington who are in precisely the same economic status, income taxes, as citizens of the immediate neighboring State?

Why does this always appear this way rather than in the form of the elimination of the deductibility of State and local taxes in general?

Dr. **Penner**. What you are illustrating is how hard it is to do these things, because we certainly were not being nice guys in picking the various options in this book. I think——

Senator **Gorton**. I do not see any option, though, for the elimination of the deductibility of State income taxes.

Dr. **Penner**. No, we have not done that. Let me talk about the sales tax first, though. I think one of the major reasons that this appears so often is as an issue of simplicity. It is a complicated thing for people to put on their tax forms. They often have to use rules of thumb to compute how much it is, since few people keep records. And if you do keep records, the sales tax——

Senator **Gorton**. Without exception you use a table, which your 1040 has to make that determination.

ALL OPTIONS HAVE DISADVANTAGES

Dr. **Penner**. Yes, that is right. You can use the table or you can keep records and that is a very arduous thing. In each of these options has the advantages and disadvantages stated. The disadvantages are just as you have elaborated them—that you hit different areas differently. And if you think of the second round of that effect, you in effect give States and localities the incentive for moving away from a sales tax to some other tax source.

So, all of these things have disadvantages. The one just on the opposite page, for example—eliminating income averaging—has many other features. Here you take away something that some people gain a big advantage from, whereas other people care less.

So, few of these options on either the spending or the tax side affect everybody equally. Indeed, that is why it is so difficult to take——

Senator **Gorton**. The point I wish to make is that this is one in which the disadvantages which you list there are so easily removable even in setting up the example in the first place, not to mention the fact that your revenue gain is greater if you simply remove the deductibility of the principal tax paid by the people of each State. There is still going to be a great deal of resistance to it. There is no question about that, but at least it loses that unfairness.

If I can, I would like to ask you one more question and I have not been able to go through all of these options, obviously, at this point. It relates to the defense budget.

RANGE OF DEFENSE REDUCTION OPTIONS

What would you estimate to be the range of defense reduction options that the committee could reasonably consider, reflecting on the degree that significant portions of expenditures are to a certain or to a large extent locked in? And would that range of viable options under any circumstances in your view allow us to deal with a level of defense finding lower than the CBO baseline for defense?

Dr. **Penner**. Well, sir, on the second to the last page of my testimony, I note that to achieve the baseline would require $174 billion that is cumulative between 1985 and 1989. Is that practical? I think one could conceive of it easily. The point is——

Senator **Gorton**. How many dollars would that be for 1985?

Dr. **Penner**. About $16 billion for 1985.

Senator **Gorton**. So that would put us for all practical purposes, the number that we came for for 1985 in the 1984 budget resolution, would it not?

Dr. **Penner**. That is exactly right.

Senator **Gorton**. Would the same thing hold true for the next succeeding year, for fiscal year 1986? Would that put us on that path?

Dr. **Penner**. In 1986 the difference in budget authority between the budget resolution and the administration is $30 billion.

Senator **Gorton**. Would that put us on that $174 billion line by 1989?

Dr. **Penner**. Yes. You do have to be careful with it, sir, because we are assuming different inflation rates, too. We have not yet completed our analysis of the President's budget line by line, and probably the most complicated area there is the defense budget. And we have not recomputed our inflator for their 1985 proposal. So I cannot answer that with precision right now. We should have our analysis completed by February 22nd.

REACHING CBO BASELINE WOULD BE DIFFICULT

Senator **Gorton**. In any event, reaching the CBO baseline would be a very difficult proposition, given decisions which have already been made, would it not?

Dr. **Penner**. That is certainly right. You would have to consider things like stretching out modernization and so on, which have costs of their own, both in the risks that you are taking and sometimes in the fact that you would be paying more per unit for various weapons systems, and so on. It can be done, no doubt about that. But it does have a downside like everything else.

Senator **Gorton**. Thank you, Mr. Chairman.

Senator **Quayle**. Thank you. Senator Exon.

Senator **Exon**. Thank you very much, Mr. Chairman. Dr. Penner, we welcome you here.

I cannot tell you how much we rely on the figures of your department and have over the years trying to make better the difficult decisions that we have to make here. Let me get to a few questions that I think would be very enlightening for us.

CURRENT POLICY DEFINED

First, I am looking at page 61 of the economic outlook here and I see at the top of that page that you have projected the budget deficits for 1983–well, what they were for 1983 and clear through 1989. And it is headed "current policy," and it starts out with the known deficit of 195 in 1983 and goes up to $326 billion in 1989.

And I assume that when you mean current policy, that means if we would just continue on our present spending levels and present revenue levels through 1989 without any changes. Is that right?

Dr. **Penner**. Yes, with the important exception that that depends crucially on increasing defense budget authority at 5 percent per year in real terms throughout the period.

Senator **Exon**. And that—in other words—well again that is about—that is quite near current policy because we went up about 5 percent last year. So would that not come back to—if we continued our current spending policy in defense also, quite close, is it not?

Dr. **Penner**. That is how we are defining it, yes. We are defining that for these purposes as current policy.

Senator EXON. So, it is fair to say that then including total spending and social programs and defense and revenues under current tax law, level of spending under current law for social programs and entitlements and continuation of the current program of about 5 percent real increase in defense.

Now, where in the book or is it in the book those same budqet deficit figures by year under your best judgment what we would see under the President's budget?

Dr. PENNER. That is not in the book. The book had to be written before the President spoke. Now, CBO will be looking at that much more closely. The House Budget Committee staff put together some very quick estimates of the effect of the administration's proposal, given CBO's economic assumptions. And the deficit number that they came out with in 1989 was $261 billion. That, I should add, puts in just the nominal defense request of the administration. It does not try to adjust that for our somewhat higher assumed inflation and higher defense goods prices.

Senator EXON. You mean the House figures were based on less than a 5-percent real growth in defense for that period?

Dr. PENNER. No. The House approach was to take just the dollar figures in the President's request and put them on the table just as they are. Now, the President's budget assumes less inflation than our outlook does, and even given the inflation rate, assumes somewhat less increase in the cost of various weapons.

FIGURES WILL NOT CHANGE RADICALLY

Senator EXON. Well, the big problem that we have with all these numbers, we lay people, Doctor, is that everybody says—and I recognized that that is an accepted way for economists to talk—if this happens, that will happen. What I would like to know is that if your GNP figures are right, if your inflation figures are right, if you just took the President's numbers and plugged them into what you think is a less rosy picture of growth and certainly a significantly higher figure for interest, where would we come out yearly on those figures across the top on page 61?

Dr. PENNER. I do not think it does that much harm in that context to use these numbers that the House did. We will be refining them, as I said. They had to do them very quickly to read them to you. Fiscal year 1984, $189 billion; fiscal 1985, $190 billion; 1986, $210 billion; 1987, $236 billion; 1988, $249 billion; and, 1989, $261 billion.

Senator EXON. Thank you. That is helpful.

And so you are not saying now that those are what your figures will be, but is it safe to assume as far as you know right now that those figures are not likely to be radically different?

Dr. PENNER. No, sir, I do not think they will change radically. Again, I am afraid I have to return to this complicated issue of defense. These numbers will go up to the extent that we reestimate the President's defense request and find it costs more than those numbers imply.

UNDERSTANDING OF PAST WILL HELP MAKE DECISIONS

Senator **Exon**. Now, let us go off into the field of philosophy just a little bit, economic philosophy. It is certainly an inexact science. I agree. But we have to have some basis to know what we are working on here. We are all talking about the inexact science, as I said, of economic forecasting so as to help us as best we can on the important decisions that we are required to make as members of the Budget Committee.

It seems to me we are likely, Doctor, to be further off in our efforts to be reasonably accurate, and therefore responsible if we do not recognize the base or a reason for the economic surge in 1984 and 1984.

Well, I think that was most uneven and I am not so sure that things are as rosy as sometimes those economic reports indicate.

Nevertheless, we all would like to see that continue as best we could or dampen somewhat if that is in the interest of some long term growth. In other words, we have a better chance, it seems to me, of what we should do in the future if we can further understand what "current policy" has done and what part of current policy is the major part responsible for the apparent recovery.

And if we can get to that, then it would seem to me that we would have a base from which we could start to solve the problems of the future. And we all know what they are.

Do you generally agree with that philosophy, that we have to know where we are now and how we got there to best define restraint in policy to reach what we would all like to see in the future, which is steady, reasonable economic growth?

Dr. **Penner**. Certainly an understanding of the past will help us make those decisions.

Senator **Exon**. The past and present.

Dr. **Penner**. Yes.

HIGH DEFICITS LEAD TO SHORT TERM ECONOMIC UPTURN

Senator **Exon**. Now, given that, I would like to get into your best judgment as to what has been the prime factors or cause of the economic recovery that took place in 1983 and 1984. I suspect that one of the main ingredients of that recovery was the high deficits that we see, which is another way of saying we have allowed the deficits to skyrocket, which pumps money into the economy as a stimulus and certainly has not economic history shown us that generally when that one factor happens, does that not generally lead to at least short term economic upturn?

Dr. **Penner**. Yes. I think there were two factors, though people can argue about their relative importance: the one that you mentioned and shift in monetary policy in the summer of 1982. Whether you measure the shift in terms of the change in the growth of the money supply, or whether you measure it by interest rates, it was a pronounced shift and helped simulate the recovery. So I would certainly give it equal importance.

On figure 1[1] in my prepared testimony, in the bottom righthand corner, you can see the course of interest rates during the current recovery. While those are real interest rates (that is, adjusted for inflation) and while I am not one to argue that the Federal Reserve System can have much effect on those real interest rates over a very long period of time, in the short run——

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[1] See p. 413.

Senator **Exon**. In the short term they can.

So what you are saying is that high deficits which stimulated the economy coupled with a lowering of interest rates by whatever or not the Feds did was a primary factor, right?

Dr. **Penner**. Yes, that is correct.

BURST OF SPENDING HAS SHORT-RUN POSITIVE EFFECT

Senator **Exon**. Now, let me take you one more step down this road. In addition to high deficits and loosened money supply figures by the Fed, do we not generally have good time—do not the good times generally roll when we have massive tax cuts?

Dr. **Penner**. I think it depends on when they occur and how much they are connected with cuts, on the spending side as well. After some wars, we have had massive spending cuts and tax cuts and at first, the economy has gone downwards. After a while, it has really perked up.

But obviously, if all else were unchanged when we cut taxes, the deficit would go up. So we come back to your first point, really.

Senator **Exon**. And, third, in addition to high deficits and loosened money supply and massive tax cuts, fourthly, do not the good times generally roll when we are on a wartime footing as far as our economy is concerned?

Dr. **Penner**. Again, in the short run, yes. It is very important to emphasize, though, that all of these comments we are making now really pertain to the short run, which I would define as less than a 2-year period.

Again, yes, there is a shortrun positive effect from spending. That effect from the defense budget as a whole is not necessarily very different from other kinds of programs. It depends very crucially on the mixture of expenditures in the proposed defense policy, or in a public works program. The timing of spending is particularly important. But, yes, with all else held constant, a burst in spending of any kind does have a shortrun positive effect on the economy.

As I noted a little earlier, I think that effect is being muted—very—as the United States becomes more and more an integral part of the world economy. Whenever we tend to raise our deficit, that tends to put upward pressure on our interest rates, which tends to attract foreign capital from abroad. That in turn tends to raise the value of our dollar. Then our trade balance deteriorates. And that effect offsets some of the stimulative impact of either a spending increase or a tax reduction.

HIGH DEFICITS WILL CONTINUE

Senator **Exon**. Mr. Chairman, my time is up, so I will yield.

I just want to summarize briefly by saying the point I think we should remember is that high deficits—if the things we have gone over, and I think they are—then high deficits are going to continue. We can continue to expand those deficits if we want and we will mainline—we will stimulate the economy even more. We probably are not going to have any more tax cuts. The money supply, who knows what the Fed is going to do to that.

Fourth, I think there is little question but what from a historical matter, we are going to continue on a wartime economy.

Those are just some of the things that I think maybe we should understand very thoroughly as we try to put together a responsible budget. I thank you, Dr. Penner, and I thank the chair.

Senator **QUAYLE**. Thank you, Senator.

Dr. Penner, I was struck by your comments to the chairman on trying to stabilize the ratio of debt to GNP. Do you have a figure of where we should try to stabilize that ratio of debt to GNP and what might be an acceptable ratio?

Dr. **PENNER**. No is the short answer. The point is, sir, that that came up because we sit around CBO grasping for a concrete standard that might be reachable and make some sense to use in the current circumstances. And I think it fair to say that that is one of our least demanding standards. Now, it will be very hard to reach that; do not let me hide that fact.

My own approach is that if we could achieve a standard like that, which would just stabilize the debt to GNP ratio, then we could discuss what to do next. But that will be a while.

This does not go directly to your point, but really three pages from the back of my testimony, there is a chart.[1] The chart in the middle of the panel, if you peer at that quite closely, but I think a pretty clear message comes out, namely, that whenever Federal borrowing goes up, private borrowing tends to go down. And there are some economists who feel that, as you add to the Federal debt-GNP ratio, you are going to reduce the private debt-GNP ratio; there is a rather close linkage.

Senator **QUAYLE**. Well, the reason I was struck by it is because in the past—and I believe—I know I have talked to you privately about this, that we look for percentages of GNP as to where spending ought to be and where revenues ought to be. And there is a lot of discussion; people are all over the lot. Don Regan had—I think he was around 20, 21 percent where Stockman was a little bit higher, 22, 23.

Dr. Feldstein did not want to get into the question and just avoided it, but not completely. He could not afford it. He has enough disagreements.

Senator **BIDEN**. He might have been shot in the back of the head from the back of the room.

STABILIZING DEBT TO GNP RATIO IS FIRST HURDLE

Senator **QUAYLE**. He already has been a couple of times.

But what you are now saying is that we should have at least a guideline of where we want to be of the acceptable ratio of debt to GNP and that a thing called a balanced budget is illusory, because if we try to stabilize the budget on a ratio of debt-to-GNP, whether it is 2 percent or 3 percent or 1.5 percent, then we have gotten away from a debate that has been going on here for a number of years, that is, the percentage of GNP that we ought to spend on revenues or, more realistically, what percentage of GNP ought to be on expenditures.

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[1] See p. 431.

I ask you to respond to that. If in fact we get over to this benchmark, then are we not accepting in perpetuity that we are going to have this debt. It is just a matter of how big the debt is going to be.

Dr. PENNER. Let me be clear about what I was trying to say. We have a race to run with a number of hurdles, and one problem might be defining the hurdle. I was just suggesting stabilizing the debt-to-GNP ratio as the first hurdle you might want to aim to get over. But I did not want to imply that whatever debt-GNP ratio hurdle we happen to get over, that hurdle is the right one. After that, it seems to me, then we can start talking about actually reducing the debt-to-GNP ratio.

On the same page that I was referring to before, you can see what has happened to the publicly held Federal debt relative to GNP. I think 1974 is a very important year in that chart, because after being on an extraordinary downtrend all the way from World War II, we bottomed out in 1974; since that time, that ratio has been on an accelerating upward trend in our projections. The reason that I hold that important is manifested on the left portion. And it is the Federal interest payments that I would like to see stabilized relative to GNP. These interest payments are frightening; there is no other word for them. So a stable debt-to-GNP ratio would be the first hurdle, not our ultimate goal for all time. Indeed, if you pushed me harder, I would say that there is a great deal to be said for them thinking about policies for reducing the debt-to-GNP ratio.

Senator BIDEN. Would the Senator yield on that point?

Senator QUAYLE. Go ahead if you wanted to follow up, because I wanted to follow up on it.

REDUCE DEFICIT RATIO

Senator BIDEN. No, I was going to follow up on his last point; instead of stabilizing, which I do not know—the deficit is presently what, 5 percent, 5.2 percent, somewhere around there. The figures change. It was 6 percent last year, I think, to GNP.

Dr. PENNER. It is more. It is a little over 30 percent, I believe.

Senator BIDEN. Yes, well, I am talking about just the deficit, the deficit itself. If we get that debt-GNP ratio at least stabilized at 30 percent, you are going to have to really—not stabilize—it is going to have to go down.

Dr. PENNER. I gave the example before of doing it in 1987. That would mean a substantial reduction in the deficit-GNP ratio compared to current levels.

Senator BIDEN. If I could follow up on that point, Doctor, and I want to join everyone else in complimenting you on carrying on the tradition of the office that you now hold, as they say in sports, calling them like you see them. And it is not a very comfortable position, I am sure, right now. As a matter of fact, I wondered why you took the job.

But at any rate, it is a difficult position. But as I understand the point you just made—and I happen to concur with it if I understand it correctly—is that the notion that we are going to make phenomenal turnarounds here is one that we should hope and pray for and wish for, but it is not very realistic. You have to do first things first and it would be significant and it would be a monumental step, in my view, politically if we were able to do just as you said.

Dr. **Penner**. I think that is right.

NO ONE WANTS TO DEAL WITH DEFICITS

Senator **Biden**. Now, that does not mean that that is the end. That is the first step.

Let me speak to a question which I think is going to haunt us politically, and it is going to haunt us in a way—and I am not asking for a political answer. Believe it or not, I am going to ask for an economic response, if I can, and sometimes they are not very different.

But we have been trying here—and I think there is some good faith on both sides of the aisle—to see if we can declare a truce and begin to deal this year with what none of us really would like to deal with this year.

We Democrats do not really want to deal with it this year; the Republicans, I would respectfully suggest, do not really want to deal with it in an election year. And the President, in my view, thus far has not demonstrated he wants to deal with it. And that is deficits. And the action which you take, none of which is good from a political standpoint.

I mean, there is no real upside in taxes; there is no real upside in cutting social programs; there is no real upside in cutting defense. So the tendency here will be to stand back.

We are trying to go against that tide a little bit, particularly in this committee. Now, you may not have the answer to this question at this point, but what may make it a little difficult is if some of us here yield to the temptation of dealing with the deficit by something that sounds reasonable to the American people, and that is a constitutional amendment to balance the budget.

I mean, that really sounds good. I like that. I mean, I think that is wonderful and they say most states, have it and look at how they are doing. In my state we do it.

Now, what we always focus on, it seems to me, and I have tended to do it in this committee, is the political reality of being able to do that.

Rather than ask you that question, let us assume—and if you do not know, I would like an answer from you folks at CBO on this. Let us assume we passed an amendment—and I forget how many State legislatures have already voted for it.

Senator **Quayle**. Thirty-two, thirty-three, something like that.

Senator **Biden**. And let us assume we passed it here in the Senate and the House and it was ratified this year and it was in effect for 1986.

What would be the economic impact of having to cut spending and/or raise revenues by whatever combination in 1 year. Say it took place in 1986, of having even taking the President's figure of $177 billion deficit in 1986, your current policy budget with strong economic growth of $217 billion, your low economic growth figure of $267 billions. You may not have the answer, but if you do, I would love to have it. And if you do not, I would like to get it.

POTENTIAL SHOCK WOULD BE DANGEROUS

What would be the impact upon recovery and economic growth if in 1 year, 1986, we had to either raise revenue and/or cut programs a total of $177 billion, $217 billion or $267 billion? Do you have that?

I mean, that is tough; I do not suggest that you do, but if you do not, I think a serious study of that is important in order to prevent us so we get the national press people to be able to call those of us who propose that the charlatans that we are if I am right about the economic impact.

That tends to scare some of us off demagoguery. But if we do not have you putting those figures out on reliable sources what the impact would be, then those folks out there in the press are not able to say with any degree of certainty that we are demagogs and we demagogs, myself included, may yield to the temptation. I know the polls in my State show 70 percent of the people are for a constitutional amendment.

Dr. **Penner**. Let me say in response that I think it is quite obvious that the potential shock of a shift in fiscal policy within that year would amount to 5.1 percent of the GNP. The potential shock is so tremendous that no one would contemplate it. What would happen under those circumstances—and most of the versions of constitutional amendments that I have seen provide for approving a deficit with some sort of super majority, two-thirds or what have you—I do not think it would be hard to get an increase in the debt ceiling that everybody knows is needed. But I do not think it would be hard eventually to get the super majority for going ahead with the deficit under those circumstances.

Senator **Biden**. I know that, but really what I would like to know—and I am not being facetious. This is a very serious question. I would like to, with the permission of the chairman, if you have not done it, ask you to run the figures on what your estimates would be if in 1986 we were required as a matter of law to balance the budget.

Now, the reason I say that—and you and I both know there is no way that could be done. But the public does not yet. The press does not yet. They know we would all vote—you know—come up with a super majority to continue the deficits, which means it would be a bit of a sham.

But the American public believes, in my view, they believe that if that old Congress just sets their mind to it and they just had the political will and they just stopped fighting with one another, they could balance this budget. They could do it. I know they could.

Grace says you can do it just—you know—we would just start right now. You know, but really and truly that is the impression.

So I really think it is important that a credible organization—and there is now none more credible in the country than CBO—give an honest assessment. And I would like to formally request that you all prepare, run the econometric models that you would need to do, like you do in all others, as to what the effect, in your opinion, and you can give it high and low parameters, any way you want to say it, but what the effect would be to the economy if we cut out $177 billion in 1 year, your figure of whatever it is, $217 billion and $267 billion, the three options, what the effect on economic growth in this country would be, if that were to happen.

Dr. **Penner**. We would be pleased to try and do something on that for you. I have to say that it would be such a fiscal shock relative to what we have ever done in past history—aside from major wars—that I do not have a lot of confidence in our models and our economic theories to be able to handle it. But we can certainly contemplate the problem and give you some response.

Senator **Quayle**. I think that what maybe the Senator could do is to follow up with a letter that would detail more specifically how you would like to see it done, whether there ought to be more on defense or less on defense.

Senator **Biden**. Well, I really do not care how——

Dr. **Penner**. But that is important, Senator.

Senator **Biden**. All right. Well, what I will do, I will set out——

Senator **Quayle**. I think what you can do is to go ahead and follow up with a letter and I am sure that they would be more than happy to respond. But you are going to have to be a little bit more specific.

Senator **Biden**. I will. I will set out different scenarios that we hear talked about here; one, massive cuts in defense, one, massive tax increases. I will come up with ways.

Dr. **Penner**. We will have our staffs work together on that.

FUTURE IS SLIPPING FROM OUR GRASP

Senator **Biden**. OK, I would be anxious, because I really think it may be the one thing—and I am not being facetious—I am completely sincere about this—the one thing that may force us in this Congress, in this committee, to do what has to be done because based on what I have read that you all have said, based on what I have read that every other reputable economist has had to say, the future is slipping from our grasp

If we do not begin to make some moves now, we are not going to be able to turn around in my tenure, even if I am reelected to the U.S. Senate the next 6 years, the economic glidepath that we are on. I just do not see any way short of a disaster that we are going to be able to do that and unless we make the move now.

We cannot wait until next year, and it is going to take some real stiff medicine. As long as all the Democrats and Republicans know we are in the barrel together, that is the only thing I have found—if I can make an analogy to social security, Mr. Chairman, it was not, even though the Democrats, I thought, took unfair advantage of the Republicans on the social security position, it was not until we all got in there and all signed up for some of the bad medicine and everybody was able to say—and we knew the President was going to get some credit, the Democrats were going to get some credit and the Republicans are going to get some credit, and conversely, they were all going to get some blame.

It was not until that happened that we did something on social security. I would argue, we are in terms of Federal fiscal policy, we are today where we were with the social security system 2 years ago.

But, I mean, had we not moved then, it would even be worse. And we are, I think, David Stockman is correct. We are on the verge of chapter XI as a country. And I really believe that.

SOMETHING HAS TO BE DONE NOW

Senator QUAYLE. No, I think that the point you make, is that we have got to do something now. The so-called down payment meeting that is going on today is going to be very, very important, and I hope we can do something.

Senator BIDEN. Dan, I am just afraid that some of our colleagues who do not share your view and mine on both sides of the aisle are going to find that it is politically useful to scuttle what I believe is a genuine effort on the majority of the Members of the Congress and the President's advisers to come up with something. This is a little bit like going out, with no pun intended, hunting quail. [Laughter.]

Senator QUAYLE. Do you want to do that?

Senator BIDEN. I do not. I do not do that. I do not do that, nor will I do that. But the point is that I am very skittish. What happens is one false shot fired and you will find all those folks lying low in the field. They are going to stand up and take out their guns and start shooting.

That is what is going to happen around this place. And you know it as well as I do. I have only been here a little over a decade, but I know. I have watched this place. I know how it works.

And the first person—this could all be going well and you are going to have someone stand up, take that first shot, and everybody is going to—they are going to take out their guns and start shooting. And they are not going to be shooting at a target. They are going to be shooting at each other and the whole thing is going to fall apart. And I think somewhere, somewhere along the line someone has to say with some degree of substantive evidence, that if we by any configuration, were to cut $177 billion or up to $267 billion from the Federal budget and/or raise taxes that much in 1 year, we would have an absolute worldwide economic disaster on our hands.

Now, you may not agree with that. That is my view. I would like to get some figures on it.

Senator QUAYLE. You can follow up on it, but I might just say one thing, that I do not think anybody is proposing that we are going to balance the budget; maybe somebody is going to come up with a balanced budget amendment this year or next year. Some are being offered and we will go through and we will see exactly what it is.

But I think that the constitutional amendment to balance the budget does not require us to balance the budget in 1985 or 1986. What I think it does is recognize the political imbalance and the problems that we have gotten ourselves into and it is a political amendment, not an economic amendment.

Senator **Biden**. I can name two colleagues of ours who will be out there and talk about we can balance this budget if we just had the courage. And I am not suggesting——

Senator **Quayle**. We will see how they propose it and maybe after your followup, you might want to come forth with it. You are running this year.

NO CREDIT CRUNCH ANTICIPATED

Dr. Penner, you said in response to either Senator Chiles or Senator Domenici that in the next couple of years you did not anticipate a credit crunch. Could you expand on that because it seems to me if we continue with the next year, the next couple of years with approximately a $200 billion deficit, that there is going to be a credit crunch unless there is just a very loose monetary policy. Chairman Volcker indicated the other day and is probably reiterating at this moment right now with the Senate Banking Committee that he does not intend to pursue that course.

So if we do have those deficits that we are projecting, how is it that we will not have this credit crunch in, say, 18 or 24 months from now?

Dr. **Penner**. Well, again, that is a forecast put forward quite tentatively, but it is our best guess based on the notion that the rate of growth of the economy during the recovery is slowing down over the forecast period. On a fourth quarter over fourth quarter basis, the real growth goes from 4.7 percent to 3.7 percent in 1985.

You have a good cash flow in the corporation. The Federal budget over that period as a share of GNP and national savings is actually going down. As you would expect, the very worst deficit relative to GNP occurred in the trough of the recession, in the fourth quarter of 1982. From that time, through most of 1985, things get better in that respect. Then they get a lot worse after 1985.

So, as I also mentioned several times, interest rates are the hardest variable to forecast. Looking at the accuracy of past CBO forecasts, that's the thing we do worst of anything we do. But that is our judgment—because of some slowdown in the rate of business investment, because of cash flow to corporations, because of quite a substantial surplus in the pension funds of State and local governments. Adding up all the sources for savings and investment, we do not see interest rates going up sharply, which I assume is your definition of a credit crunch. But that statement does not make me at all happy. Maybe I misinterpreted your definition of a credit crunch. If you look at page——

Senator **Quayle**. You have interest rates going up marginally in calendar year 1984.

Dr. **Penner**. Marginally. That is right.

Senator **Quayle**. Then coming back down a little bit in 1985.

Dr. **Penner**. Very marginally. But I think——

Senator **Quayle**. That is the thing that intrigues me, how it is going to go up in 1984 but yet come down a little bit in 1985 with these huge anticipated deficits because we have had a lot of testimony that the deficits do have upward pressure on interest rates, that the expectation on inflation has upward pressure on interest rates.

PATTERN SIMILAR TO PREVIOUS RECOVERIES

Dr. **Penner**. Let me differentiate between two points, the change in the interest rates and the level of interest rates. We think the astounding level of the interest rates is associated with the very high level of the deficit.

If you will turn to figure 1 in my testimony, which follows page 5,[1] in the lower right-hand panel we have interest rates corrected for inflation. And you can see how much higher interest rates are now than the average during recoveries—that is in the post-World War II period. So by some definition, I suppose you might say there is a credit crunch. And I do not want to rule out the possibility that if we could get the deficit down somehow, those rates would come down. My only point is that, in our short-run outlook—that is to say through 1985—we do not see these government demands on credit markets getting worse than they are at this moment. Therefore, while the level is much higher than in previous recoveries, we anticipate following a pattern very similar to that in previous recoveries. You can see there it just sort of wiggles around a bit but essentially remains flat. So that is the theory behind this. Again, though it may be a semantic difficulty of how do you define credit crunch.

Senator **Quayle**. After 1985 you still have a fairly level or lower rate of interest.

Dr. **Penner**. At that point we say very clearly in our analysis that——

Senator **Quayle**. You cannot predict that.

Dr. **Penner**. We cannot forecast that. It is not meant to be consistent with current policy. It indeed is at that time that the deficits start to rise relative to GNP and to rise very rapidly. And certainly, if we went along that path forever, I think I can say with some confidence that we would not have the interest path that we have in our longer run historical projection. But indeed, we would have it rising.

This it is a tradition in these sorts of projections, simply because we know that policies are not going to remain absolutely constant for that long a period. It is rather foolish to base a baseline on the assumption of absolutely constant policies. So we have always referred to past history in doing those longer term projections.

ASSUMPTIONS ON MONETARY POLICY

Senator **Quayle**. Assuming your projections through 1985, which are reasonably optomistic, what kind of assumption do you make on the monetary policy? What are you plugging in there?

Dr. **Penner**. Very precisely, we assume that the Fed keeps exactly in the middle of the range that they announced yesterday. That is to say, as far as the narrower money supply concept is concerned, the so-called M1, that grows at 6 percent a year through 1984. Then Chairman Volcker has talked a lot about decelerating that, and we put in 5.5 percent growth through 1985. Now, that sounds more mechanical than I mean it to be. That statement is based on the assessment that the demand for liquidity in the economy relative to incomes remains about the way it has over past history.

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[1] See p. 413.

Obviously, we think that if something odd happened—and a lot odd has happened over recent months—and the demand for liquidity changed in some surprising way, the Fed would adjust for that. Indeed, I told Chairman Volcker that we do not ask much of him. We'd just like to see him make our forecasts come true. And given changes and the demand for liquidity, that might involve a departure from those assumptions that we have laid out.

Senator **Quayle**. Senator Chiles.

CBO'S ANALYSIS SIMILAR TO COUNCIL OF ECONOMIC ADVISERS

Senator **Chiles**. Dr. Penner, in the Congressional Budget Office's economic outlook an entire chapter is devoted to an analysis of our international trade sector. Dr. Feldstein believes that high interest rates created by the huge budget deficits are the cause of our serious trade problem. Secretary Regan believes that that high trade deficit is unrelated to our higher budget deficit.

What does your Congressional Budget Office report say about the relationship between budget deficits, interest rate, and our trade imbalance?

Dr. **Penner**. Our analysis is very similar to that found in the economic report of the Council of Economic Advisers. That is to say, we see the linkages going from the domestic budget deficit to high real interest rates, attracting foreign capital, increasing the value of the U. S. dollar, leading to the great deficit. So it is an indirect——

Senator **Chiles**. So, high interest rates, which are caused by the high defict, attract foreign capital, which in turn raises the value of the dollar and causes our exports to suffer in relation to foreign imports and that leads to the trade deficit.

Dr. **Penner**. Yes, I think there is a very definite link through that chain.

FOREIGN MONEY FINANCING BUDGET DEFICITS

Senator **Chiles**. To what extent is the foreign money financing our budget deficits? Do you have any idea? Do you have any figures, any relations of what we are really talking about here?

Dr. **Penner**. I think it is important to look at that more generally. If you ask, "How many Treasury securities are foreigners buying?" It does not necessarily show up there real directly, although it does to some extent. But I think the more important point is that our deficit puts pressures on our capital markets generally. It makes it harder to sell State and local bonds, corporate bonds, et cetera. And the foreigners come in and take some of that pressure off. So, indirectly, they are financing a good part of it. We have the merchandise trade account deficit going out to——

Senator **Chiles**. Tell me what the merchandise trade account is?

Dr. Penner. That is essentially the trade in goods. And that deficit was $42.6 billion in 1982. We had $70.6 billion in 1983. And we have it rising to $104.9 billion in 1984 and $118.5 billion in 1985.

The current account balance—that is to say, what you get when you include the trade and services of foreigners and the payment of interest and dividends and add that to the goods trade--that goes up from $47.4 billion in 1983 to $95 billion in 1984. That is the counterpart of the capital inflow. The balance of payments has to balance. You have got to have a current account deficit to offset what comes in. So that is a shift of almost $50 billion in those 2 years.

So again, as you describe, while it is causing us a lot of trouble in our export industries and our import-competing industries, on the other hand, we have to be thankful that we have it, because it is quite clearly keeping our interest rates down.

Senator Chiles. My question is, What are the risks associated with letting this go on?

Dr. Penner. The obvious risk is that we are dependent on the confidence of foreigners.

Senator Chiles. The risk is that prop might be pulled out from under us.

Dr. Penner. At any time, yes.

Senator Chiles. Thank you.

DECLINE IN UNEMPLOYMENT FOOLS FORECASTERS

Senator Quayle. Thank you, Senator Chiles.

I just have one final question. Why did we have such a dramatic decline in unemployment in this last year that nobody forecast? People expected a much more gradual decline, and yet we have seen it drop rapidly. And most forecasts are that it is going to continue to go down a little bit more and then sort of level off. What did we miss?

Dr. Penner. I can give you a definitional answer to that, which does not give much understanding, because we do not have much understanding of it. The basic point is that employment rose very much more relative to the increase in production than you would normally expect at this stage of the business cycle. That has a bad side to it as well. That is just another way of saying that the productivity of workers grew over this early stage of the business cycle somewhat less than we expected it to. The other point—that is one component of the problem is that the labor force growth was much less than we expected. You had fewer people coming on the job market looking for jobs than we had predicted. That is a bit puzzling.

If you look at the recent history of the business cycle—that is to say, going back I think late 1960's and 1970's—we based our forecasts on that recent history. And during that recent history, the labor force growth has tended to accelerate during a recovery period. People sort of come out of the woodwork and start looking for jobs who were not out there before.

If you look at the whole postwar period, though, that does not happen so much. What has actually happened during this recovery is much more in line with what happened over the whole average long term of postwar history than it is of recent history. So we have been fooled by that. But to try and tell you that we have some understanding of why that labor force did not grow as much as we thought, we just do not have really very good understanding of why the productivity did not grow as fast as we thought, or in other words, why employment went up so much relative to production.

Frankly, sir, the numbers are so puzzling to me that I would not be at all surprised if they are revised. Come July, as you know, the Department of Commerce revises all the past history for us. That is part of the fun of being an economist. Statistics explain the past and then the past changes on you.

But it is a real puzzle.

LABOR FORCE CATCHUP FORECASTED

Senator **QUAYLE**. Do you anticipate, taking the second part of your equation, do you anticipate that there will be fewer people coming into the labor force in the next 5 to 10 years than what we have had in the past decade?

Dr. **PENNER**. There is the demographic change, of course, because of the teenagers; there are not so many teenagers around. But in the shorter term, we in fact have in our forecast the notion of some catchup in the labor force. But we could not explain the fourth quarter very well—basically, not at all. So we say that early this year, we will have some more inflow into the labor force. If that does not appear, then the unemployment rate, given our other assumptions, will do better than we are forecasting. Indeed, it was better in January than we thought it would be. In terms of the longer goal, I think we have adjusted for the demographics.

WOMEN IN WORK FORCE WILL INCREASE

Senator **QUAYLE**. What about the factor of women entering into the work force? It is now up to 57 percent, I think, which is quite an increase in the last decade. Are we going to see that stabilized at about that figure? Would that be part of an explanation that you might not have more people coming into the work force, or is that an irrelevant factor?

Dr. **PENNER**. We continue to assume some increase in female participation.

Senator **QUAYLE**. What is it now, 57 percent?

Dr. **PENNER**. It is now 53 percent.

Senator **QUAYLE**. And then what do you see it going to in the next 5 years? Do you have any forecasts on that?

Dr. **PENNER**. Let us get that for the record.

Senator **QUAYLE**. OK.

[The following was subsequently supplied for the record:]

CBO does not have separate projections for female labor force participation. Our overall labor force projections, however, are close to the "middle growth projection" published by the Bureau of Labor Statistics (BLS) in November 1983. Female participation rates in those projections rise from a current level of 53 percent to 58.3 percent in 1990.

Dr. **PENNER**. But let me make an important point while you are on the subject of the female labor force. I think it is quite astounding—in fact, it might be some sort of historical watershed—that early in 1981, the female unemployment rate dropped below the male and has continued to be below the male ever since. For almost all of the postwar period before that, it was, with some few exceptions and some recessions, above the male. I think what that may reveal is an improvement in the quality of female labor force participation in the following sense. This is all speculation on my part, but my guess is that women are becoming more attached to the labor force.

It is not speculation that, for the first time in history, they are not leaving the labor force in great numbers in the childbearing years or even when they have small children. That is a very radical change.

One of the reasons for the relatively high female unemployment rate in the past was the fact that, typically, women were going in and out of the labor force several times during their careers. That may have now changed, and if so, that is an extraordinary social change and, I would say, achievement.

Senator **Quayle**. We will follow up with you because I am very interested in trying to get a handle on not only demographics, but where our pool of eligible employees are going to be in the next 5 years. I know it is sort of a difficult figure, but I would like to sanitize it as much as possible.

I have got two questions from Senator Grassley that I will insert in the record and allow you to respond to at an appropriate time.[1]

I want to just thank you, Dr. Penner, for your contribution today. We will be seeing you many more times before this committee. You bring fine credentials and a very good reputation, and I am sure it will be intact as you go through this mind field of economic assumptions and analysis in a very objective way.

Dr. **Penner**. You are more certain of that than I am, sir.

Senator **Quayle**. That is because you are an economist.

Thank you very much.

[Whereupon, at 11:45 a.m., the committee was adjourned.]

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[1] See p. 666.

VIEWS OF OUTSIDE ECONOMISTS

THURSDAY, FEBRUARY 9, 1984

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 1:52 p.m., in room SD-608, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Chiles, Quayle, and Exon.

Staff present: Stephen Bell, staff director; and Gail Fosler, chief economist.

For the minority: Richard N. Brandon, staff director; and Garry Schinasi, senior economist for macroeconomics and fiscal policy.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman DOMENICI. This hearing will please come to order. Let me say first to the witnesses, I'm not really sure what the agenda in terms of other Senators is. At this point we have eight or nine that say they will be in and out, but I think we shall proceed.

I'd like to welcome you to the committee this afternoon. Dr. Robert Kilpatrick, who is the president and chief executive of CIGNA Corp., and chairman of the Business Roundtable, their task for, I guess, on Federal budgets. Is that correct?

Mr. KILPATRICK. Yes, sir.

Chairman DOMENICI. Dr. Richard Rahn, vice president and chief economist of the Chamber of Commerce of the United States Mr. Albert Sommers, senior vice president and chief economist of the Conference Board.

We greatly appreciate your taking time to come here. This is the last panel of witnesses we'll hear from. Some witnesses before you have testified on the need for very large reductions in the budget deficits beginning next year. Some advocate reductions of as much as $100 billion next year alone; some witnesses have advocated that we do not only make large deficit reductions quickly, but that we do so solely or primarily by cutting spending.

As you well know you take defense, social security, medicare, and interest on the debt, and you close down the rest of Government and still we can tell from the arithmetic of it you would have a slight deficit left over.

If we get anything passed, it seems to me it's going to be a mix and it's certainly not going to be any of the courses that I've just described.

I'm hopeful that we'll get a substantial start this year, more than the $100 billion over the 3 years that's recommended by the

President. I hope that you'll direct your testimony this afternoon to this very important issue. Is this down payment worth doing? I think it is. This Congress isn't going to act alone. We need support. We need encouragement.

CHAMBER OF COMMERCE'S FORECAST FOR REAL GNP CLOSE TO MARK

Allow me to address Dr. Rahn at this point. Dr. Rahn, I understand that you and the organization you represent are very proud of the fact that the chamber of commerce's forecast for real GNP growth in 1983 came very close to the mark. In fact, the chamber's forecast was closer to the actual than either the Congressional Budget Office or the Council of Economic Advisers forecast. In early 1983, your group forecasted 3.2 percent real growth; actual real growth was 3.3 percent. I understand your pride because economic forecasting is a risky business that an elite few can claim to do well.

Why don't we take a look at what happened in 1982. Actual real GNP growth was minus 1.9 percent. In early 1982, the chamber forecasted real growth for 1982 as plus 1.2 percent. In 1982, the chamber was off the mark by 3.1 percent, much farther off than either the CBO or the Council of Economic Advisers were in 1983. It just goes to show you that everyone is right some of the time, but none of us is right all of the time. I'm reminded of the one liner I heard some time ago which pertains to economists: to err is human, but to get paid for it is divine.

Each of you on the panel this afternoon are involved in economic forecasting; and I think you understand my point. Congress cannot base its policy decisions on a single set of economic forecasts. We must evaluate all of the risks in order to make prudent decisions. I hope that you and other forecasters will help us understand just what those risks are.

So with this discussion as a beginning, let's move directly to your testimony. Your support, and the support of other organizations such as yours, is essential to our success. I want to hear your views.

We are going to proceed now in the order that I introduced you. Mr. Kilpatrick, would you start? I would like very much for each of you to take no more than 10 minutes for your opening discussions and we'll put your statement in the record now. Before you start Mr. Kilpatrick, we have received a statement from Senator Hatch who was unable to be here, and without objection we will insert it in the record at this point.

[The statement of Senator Hatch follows:]

STATEMENT OF SENATOR HATCH

Gentlemen, I join my colleagues in welcoming your appearance before the Senate Budget Committee this afternoon. We look forward to hearing your advice on how to ensure our country's continued economic recovery and maintain the long-term, non-inflationary steady growth so beneficial to all our citizens.

At this time when we are all concerned about deficits and their possible long-term effects on our economy, I am particularly anxious to hear Dr. Rahn from the Chamber of Commerce and to learn his economic assumptions and projections. I note that Dr. Rahn and his colleagues called the 1983 economic recovery almost on the nose—and certainly a lot better than everyone else. They predicted a 3.2 percent real growth in our GNP, not far at all from the actual 3.3 percent rate of growth now officially recorded for 1983.

My uneasiness about growth assumptions factored into budget predictions is in response to the rosy predictions of continued—even enhanced—growth this year and next which I am constantly hearing. Yet, I also hear many noted economists warning that we could have both rekindled inflation in late 1984 because of the great surge in the money supply from July of 1982 to July of 1983 and a possible recession in the first half of 1984 due to the greatly restricted growth in the money supply since mid 1983. Despite these warnings, I have seen no budget and economic projections which reflect what the greatly lessened rate of growth, should these events occur, would do to our budget deficits. As a matter of fact, I am concerned about what even an only 1 percent lower rate of growth than that widely predicted would mean for deficits and for our economy. I look forward to hearing your thoughts on these matters.

Let me just add that I hope the result of the massive attention currently focusing on deficits will produce a recognition of the need to reexamine our national priorities in order to eliminate excessive federal spending and to pursue a long-term, slow and steady growth of the money supply, avoiding the economically detrimental swings between inflation and recession.

STATEMENT OF ROBERT D. KILPATRICK, PRESIDENT AND CHIEF EXECUTIVE OFFICER, CIGNA CORP., ON BEHALF OF THE BUSINESS ROUNDTABLE

Mr. KILPATRICK. Thank you, Mr. Chairman.

As you noted my name is Robert Kilpatrick. I am president and chief executive officer of CIGNA Corp., and chairman of the Budget Task Force of the Business Roundtable. It is in the latter capacity that I appear here before you today to present the views of the Business Roundtable on the President's proposed budget for fiscal year 1985.

I would first like to commend this committee Chairman Domenici and Senator Chiles for their leadership on budget and economic issues. Without the committee's concern and tenacity our budget process would not work as well as it does.

I also want to emphasize the commendable progress that I think President Reagan and the Congress have made in maintaining the momentum of the economic recovery.

EXCESSIVE GOVERNMENT SPENDING IS THE PROBLEM

Still, high Federal budget deficits remain, and they are very troubling to those of us running businesses. The lack of progress toward deficit reduction this past year is discouraging in two respects: First, the possible growth of the deficit to something on the order of $325 billion by 1989 cannot be tolerated with the stakes so high. Second, we need a strong rather than a weak budget process to reduce future deficits. The problem in the view of the Business Roundtable is excessive Government spending which produces the staggering deficits now built into each fiscal year. They are not entirely related to the economic cycle; rather, they are structural.

We cannot accept these numbers as normal. The risks are too great and action is required.

A great deal of our frustration in the business community results from the very limited portion of the budget which tends to be examined in efforts to reduce the deficit. Entitlements have grown to almost half of the budget, but if they cannot be addressed as a source of budget savings, how can we possibly reduce our future deficits?

The speed of the defense buildup is notable. We need to have a strong defense, but perhaps sustained at a somewhat lower rate of growth than the President has been proposing.

Interest on our accumulated debt has grown as our deficits have mushroomed. Deficits absorb our savings in the year of the deficit, and they continue to take their toll in the future.

Nondefense discretionary spending is the item which reflects the greatest irony of Federal budgeting. What businessmen normally consider the most important component in controlling spending in our own companies, descretionary decisions, is only about 13 or 14 percent of Federal spending, and has the smallest potential for reducing the deficit.

This analysis, Mr. Chairman, leads us to the conclusion that if there is to be a meaningful deficit reduction effort, all spending programs must be subject to negotiation, not just those we have called discretionary and have already cut in many instances.

MORE OF GNP BEING ABSORBED BY BUDGET

The Business Roundtable is also troubled by the size of the Federal Government relative to gross national product. Despite the President's efforts and despite the efforts of the Congress, the budget has risen and absorbs more of our gross national product than it did in 1981.

Without a serious deficit reduction program, the Federal budget may be over 25 percent of GNP by the end of the decade. As a result, in our view, Government will have control of more of our national resources than is prudent.

Budgets of these dimensions and deficits of the size we are experiencing absorb savings and threaten to drive up interest rates. They threaten to stimulate inflation, cause the dollar to be over valued relative to other currencies, and deny some measure of economic recovery to our export industries.

Our savings ought to go into investment to increase American productivity. We need to encourage private sector savings, and we need to use them for a stronger economy. But we are not doing that because of the deficit.

I recognize that there is disagreement among reasonable people on the effects of deficits. But I believe that our inability to reduce the deficits during a strong economic recovery does not portend well for the future.

It will be harder to pay this debt in a recession or with increased inflation. The longer we delay in addressing this problem, the more difficult and more protracted will be its solution.

The Business Roundtable Budget Task Force which I chair has been working actively on budget issues for several years. Our position has been to urge restraint in spending across the board, but especially to slow the growth in nonmeans tested entitlement programs.

We have also advocated that increases in defense spending which we support be set at sustainable levels. As part of our position, the Roundtable has called for a decisive downward path in the deficit to the lower of 2 percent of gross national product or $75 billion by 1988, a goal which will be difficult to achieve.

The Roundtable believes that the major thrust of deficit reduction activity must be addressed at the spending side of the budget, particularly entitlements.

In our view, the country cannot afford these programs as currently legislated.

SPENDING CUTS SHOULD BE TOP PRIORITY

Although the potential for spending reductions is very substantial, progress thus far has been limited. Spending cuts must be addressed vigorously, and in our view as the top priority. When possible spending reductions have been fully explored and action programs have been defined, it is likely that new long-term revenue sources will be needed in the fiscal years 1986 to 1988 timeframe if we are to reduce deficits to no more than 2 percent of gross national product.

Studies of both short and longer term revenue reforms should commence promptly. The longer range study should form part of the examination of tax reform. Both short- and long-term revenue programs should reflect the national need for job creation, and improved industrial competitiveness through modernization and growth.

We believe that the fiscal year 1985 budget provides a renewed opportunity to start controlling Federal spending and budget deficits. If legislative proposals in the President's budget are enacted, the deficit would decline from $184 billion in fiscal year 1984 to $123 billion in fiscal year 1989 using the President's economic and policy assumptions.

We would be pleased to see the deficit reduced to the $123 billion range even though that figure is higher than our own goal of $75 billion in 1988.

The Business Roundtable strongly endorses the bipartisan effort to make a downpayment on deficit reduction. Some progress, Mr. Chairman, is better than none, but we should not fool ourselves into believing that this year's downpayment need not be followed by some very strict long term spending discipline if the structural deficit is to be contained, and continued economic recovery assured.

None of us should prejudge the outcome of bipartisan negotations to achieve the kind of downpayment sought by the President. Our leaders in the formal negotiations should approach the issues with a commitment to a real downpayment that can be built upon next year. The problem can be solved by political will; that is what is lacking.

The Business Roundtable supports greater administrative control over expenditures. We also support the objective of the President's intention to achieve broad-based revenue reform.

The Roundtable is eager to work with the administration and Congress in this area and will be conducting its own studies this year. It is critical that we encourage more savings, and more investment by America. The tax system should not penalize those who save and invest in productive capacity that will produce jobs.

ROUNDTABLE DEFENDS BUDGET PROCESS

Finally, the Roundtable also wants to focus attention on the budget process, which it has defended strongly. The last year has been an especially difficult one with reconciliation on the fiscal year 1984 budget not yet completed. But in the last 9 years we would have been far worse off without budgets and the discipline they impose.

Any negotiations on the fiscal year 1985 budget must assure continued economic recovery by taking decisive action on the tough issues and must send the right signals to the marketplace and to the country, even though it is a political year.

The Roundtable has tried to play a constructive role in the budget debate, Mr. Chairman, and has worked with our leaders in a spirit of bipartisanship to solve this difficult national problem.

We believe that Chairman Domenici and Senator Chiles and the other members of this committee understand that proposition quite well. We trust that you will continue to exercise the kind of leadership needed to reduce the deficit and assure continued economic recovery.

Thank you, Mr. Chairman.

Chairman Domenici. Thank you, Mr. Kilpatrick.

[The prepared statement of Mr. Kilpatrick follows:]

Prepared Statement of Robert D. Kilpatrick,
President and Chief Executive Officer, CIGNA Corp.
On Behalf of
The Business Roundtable

Introduction

My name is Robert D. Kilpatrick. I am President and Chief Executive Officer of CIGNA Corporation and Chairman of the Budget Task Force of the Business Roundtable. It is in the latter capacity that I appear before the Committee today to present the views of the Business Roundtable on the President's proposed budget for FY 1985.

I want to commend this Committee, Chairman Domenici and Senator Chiles for their leadership on budget and economic issues. The zeal with which they have pursued the goal of a strong, sustained economic recovery is commendable.

The Federal budget has been a major priority for the Business Roundtable for the last few years and a matter of concern to businessmen. We in business are often frustrated by what we see as the inability of Congress and the Administration to manage budget issues effectively. This Committee has repeatedly exercised significant leadership in adhering to the requirements of the budget process. Without your efforts and concern our budget process would not work as well as it does.

I also want to emphasize the commendable progress that has been made in maintaining the momentum of the economic recovery. Inflation remains under control, unemployment has dropped more rapidly than at any other time in the last 30 years, and consumer confidence is being restored. Still, high federal deficits remain, and they are troubling. These budget difficulties are not just business concerns. They pose a basic political problem for all Americans and have resisted resolution by the Congress, the Executive Branch and by both political parties. Unfortunately, persistent deficits restrict our ability to count on a strong, non-inflationary expansion.

The Task Now Before The Congress

Congress adjourned on November 18 without having completed reconciliation on the FY 1984 budget. Now we are engaged in debate on the FY 1985 budget, with the important unfinished business of FY 1984 budget reconciliation still outstanding. The lack of progress toward deficit reduction is discouraging in two respects.

First, without changes in current legislation the FY 1984 budget deficit will be $190 billion, using CBO figures, growing to $326 billion by FY 1989. This is particularly troublesome since we cannot tolerate failure of budget discipline with the stakes so high.

The Presidential election season is upon us and will be a major preoccupation this year. Too much emphasis thus far has been placed on assigning blame for the budget controversies, not enough on finding solutions. Our national interest demands serious action to reduce the federal deficit. We must focus resources and ingenuity to manage expenditures and revenues.

My second concern is that the budget process must work this year if momentum for deficit reduction is to be maintained after the election. We need a strong, rather than a weak budget process to reduce future deficits.

The Problem

The problem in the view of business is excessive government spending which then produces the staggering deficits which are now built into each fiscal year. We have become somewhat numb to descriptions of budget deficits. We can even utter the phrase "$300 billion deficit" without looking at the paper twice to see if there wasn't simply a typographical error. When President Ford presented a budget with a deficit in the $60 billion range, the number was the highest ever and received considerable attention. In FY 1984 the deficit may be more than three times as large.

The deficits we will be experiencing are not entirely related to the economic cycle, but rather they are structural. They are basic and entrenched; the easy solutions have all been considered. We cannot accept these numbers as normal. Another deficit approaching $200 billion and the prospect of annual deficits approaching $300 billion in the future cannot be accepted as business as usual.

A great deal of our frustration in the business community results from the fact that a very limited portion of the budget tends to be examined in efforts to reduce the deficit.

Entitlements have grown to be the largest component of federal spending, largely because of automatic cost of living or "COLA" adjustments. They are a political problem because they are basically middle class, broadly shared programs, and reducing their growth has not been politically popular. But they are roughly half of the budget, and if they cannot be addressed as a source of budget savings, how can we reduce future deficits?

Defense spending has increased significantly in the past few years. Although defense is not exceptionally high as a portion of our GNP in the post-war period, the speed of the buildup is notable. We need to have a strong defense; but perhaps sustained at a somewhat lower rate of growth than the President has been proposing.

Interest on our accumulated debt has compounded as our deficits have mushroomed. Not only do deficits absorb our savings in the year of the deficit, they continue to take their toll in the future. More than one government dollar in ten now pays for the past. As businessmen we have to believe that this is not the kind of policy that encourages long term financial stability.

Non-defense discretionary spending is the category which reflects the greatest irony of federal budgeting. When the American people think of budgeting, and when we think of budgeting for our companies, we normally think of annual discretionary decisions. But under the current structure, the scope for discretionary spending at about 13 percent is small indeed. Thus, what we would normally consider the most important component in controlling spending in our own companies has the smallest effect when it comes to government spending.

This analysis leads us to the conclusion that if there is to be a meaningful deficit reduction effort, all spending programs must be subject to negotiations, not just those we have called "discretionary" and have already cut.

Why are these deficits so bad?

The Business Roundtable looks at the size of the federal budget relative to GNP and finds it troubling. When the

President announced his economic program in March 1981, a basic goal was to reduce the size of government and the size of our deficits. The Business Roundtable supported that goal. The President wanted to reduce the size of the federal budget to 19.3% of GNP by the start of FY 1984, which began on October 1 of this past year. The level had been 21.1% during FY 1981 and in the range of 22% during the Carter years. We all applauded this goal. But the budget has risen and absorbs more of our GNP than before. No constructive action to change this trend has been taken. For FY 1984 it will likely be in the 24% range, and without a serious deficit reduction program it will be over 25% by the end of the decade. As a result government will have control of more of our national resources than is prudent.

Budgets of these dimensions and deficits of the size we are experiencing absorb savings and threaten to drive up interest rates. They threaten to stimulate inflation, cause the dollar to be overvalued relative to other currencies, and deny in most cases hope of economic recovery in the near term to our export industries. The President told the Congress in his budget message:

> "Only the threat of indefinitely prolonged high budget deficits threatens the continuation of sustained non-inflationary growth and prosperity. It raises the specter of sharply higher inte est rates, choked-off investment, renewed recession, and rising unemployment."

Our savings ought to go into investment to increase American productivity. We need to encourage private sector savings and to use them for a stronger economy. If the deficit continues to grow as now projected, almost all of the savings available over the next five years will be absorbed to fund the deficit. Capital for private sector expansion will come more and more from foreign investment encouraged by high real interest rates rather than from net new savings by Americans. This consequence of high interest rates obscures the long term negative effects of our large budget deficit.

I recognize that there is disagreement among reasonable people on the effects of deficits. Some economists have challenged the theory that deficits absorb savings and limit the amount of money available for private borrowing. And some claim that the problem is not as urgent as we have believed in the past. Such thoughts have been honestly presented, but only history will prove which theory is right. But I believe that our inability to reduce the deficits during a strong economic recovery does not portend well for the future. It will be harder to pay this debt in a recession or with increased inflation. The longer we delay in addressing this problem the more difficult and protracted will be its solution.

The Business Roundtable Position

The Business Roundtable Budget Task Force, which I chair, has been working actively on budget issues during the past year.

Our position has been to urge restraint in spending across the board, but especially to slow the growth in non-means tested entitlement programs. We have also advocated that increases in defense spending--which we support--be set at sustainable levels. As part of our position, the Business Roundtable has previously called for a decisive downward path in the deficit to the lower of either 2% of GNP or $75 billion by 1988, a goal which will be difficult to achieve.

The Roundtable believes that the major thrust of deficit reduction activity must be addressed at the spending side of the budget. Although the potential for spending reductions is very substantial, progress thus far has been limited. Spending cuts must be addressed vigorously and as the top priority. When possible spending reductions have been fully explored and action programs have been defined, it is likely that new long-term revenue sources will be needed in the fiscal years 1986-88 time frame if we are to reduce deficits to no more than 2 percent of GNP. Studies of both short and longer term revenue additions should commence promptly. The longer range studies should form part of the examination of tax reform. Both short- and long-term revenue programs should reflect the national need for job creation and improved industrial competitiveness, through modernization and growth.

The Business Roundtable has advocated bipartisan cooperation on the Budget since 1982. We called for bipartisan leadership by the President, House Speaker O'Neill and Senate Majority Leader Baker to work with the Budget Committees. We need to break the impasse and complete the FY 1984 budget process in a manner that would encourage a sustained recovery and give the proper signals to financial and foreign exchange markets. Bipartisan cooperation this year is especially important if Congress and the President are to serve the national interest by working together on the FY 1985 budget.

The FY 1985 Budget

We believe the FY1985 Budget provides an opportunity to start controlling Federal spending and budget deficits. The President's budget proposal maintains the overall spending thrusts of his previous budgets. If its legislative proposals are enacted, the deficit would decline from $184 billion in FY 1984 to $123 billion in FY 1989 under the President's economic and policy assumptions. If no actions are taken, the deficit would remain in the $200 billion range throughout the period. According to previous CBO calculations the deficit would soar to the $300 billion range.

The Congressional Budget Office has not yet released its analysis of the President's budget, a document upon which this Committee and the Business Roundtable have both relied in previous years. We do know that there are differences in current services deficit projections between the Congressional

Budget Office and the Administration. There may also be differences in the anticipated effects of the President's legislative program which produce a somewhat different pattern of deficit projections between now and 1989.

We would be pleased to see the deficit reduced to the $123 billion range, even though that figure is higher than our goal of $75 billion by FY1988. We understand that the Congressional Budget Office may have different assumptions but we have not had the benefit of reviewing their report.

The Business Roundtable strongly endorses the bipartisan effort to make a "down payment" on deficit reduction. Some progress is better than none, but we must not fool ourselves into believing that this year's "down payment" need not be followed by some very strict long term spending discipline if the structural deficit is to be contained and continued economic recovery assured. This need has been reinforced by recent comments and testimony before this Committee.

None of us should prejudge the outcome of bipartisan negotiations to achieve the kind of "down payment" sought by the President. Our leaders in the formal negotiations should approach the issues with a commitment to a real "down payment" that can be built upon next year. The problem can be solved by political will; that is what is lacking.

The Business Roundtable supports greater administrative control over expenditures. We also support the objectives of the President's intention to achieve broad-based revenue reform. The Business Roundtable is eager to work with the Administration and the Congress in this area and will be conducting its own studies this year. It is critical that we encourage more savings and investment by Americans. The tax system should not penalize those who save and invest in productive capacity that will produce jobs.

The Budget Process

The Business Roundtable also wants to focus attention on the budget process, which it has defended strongly. In the nine years we have had a formal budget process it has worked fairly well. The last year has been an especially difficult one, with reconciliation on the FY 1984 budget not yet completed. But we would have been far worse off without budgets, without measuring expenditures against revenues and without some formal reckoning in the Congress.

Last year, Chairman Domenici invited the Business Roundtable to submit recommendations for strengthening the budget process. We took that invitation seriously, commissioned a study, and have submitted what we believe to be some practical ideas which will support a stronger budget process. We look forward to working with the Chairman, Senator Chiles and the other members of this Committee in whatever way we can.

We have four key ideas for improving this process:

1. We recommend stronger budget control by making all programs subject to explicit spending decisions. The issue here is entitlements. We call for a deindexation of all spending programs so that the Congress will make affirmative decisions about program benefit levels.

2. The budget should be unified. Right now about 3% of federal spending is not included in the official budget. That amount will increase significantly in 1992 because of the decision to remove Social Security from the unified budget. We can't have "back door" spending which isn't counted.

3. The budget process itself needs to be improved and streamlined. We proposed that aggregate spending and revenue targets in the first budget resolution be binding. Individual committees and budget functions should have binding targets as well.

4. Finally, we recommend strengthening executive direction and control of the implementation of Congressional budget decisions. The Executive Branch should develop a uniform system of variance reports and provide that data to Congress. Such information would permit an aggressive program to control spending variances by the departments and agencies. The President needs a stronger hand in seeing that spending remain consistent with Congressionally approved priorities.

Conclusion

During the past year we have been active on two fronts. Substantively, we have urged lower spending, lower deficits, attention to entitlements especially and keeping the central issue of deficits in the forefront. Procedurally, we have developed a study and the recommendations I have just described.

In the last several weeks, I have spoken with many businessmen to get their views on the budget. We applaud the progress on economic recovery that has been made. We endorse the President's effort to achieve a "down payment" on deficit reduction. But any negotiations on the FY 1985 budget must assure continued economic recovery by taking decisive action on the tough issues and send the right signals, even though it is a political year.

The Business Roundtable has tried to play a constructive role in the budget debate and has worked with our leaders in a spirit of bipartisanship to solve this difficult national problem. As businessmen we need to reinforce the idea that government should be run with the same discipline with which we run our own businesses. We believe that Chairman Domenici and Senator Chiles and the other members of this Committee understand that proposition well, we trust that you will continue to exercise the kind of leadership needed to reduce the federal deficit and assure continued economic expansion.

Chairman **Domenici**. Dr. Rahn, vice president and chief economist with the chamber of commerce. We're delighted to have you with us.

STATEMENT OF RICHARD W. RAHN, VICE PRESIDENT AND CHIEF ECONOMIST, CHAMBER OF COMMERCE OF THE UNITED STATES

Mr. **Rahn**. Thank you, Mr. Chairman. I would request that our entire statement be put in the record, and in the interest of time I'll summarize the statement.

Chairman **Domenici**. It will be made a part of the record.[1]

Mr. **Rahn**. I'm Richard W. Rahn, vice president and chief economist of the Chamber of Commerce of the United States. On behalf of the chamber's more than 200,000 business, trade association, local and State members, I welcome this opportunity to present our views before the committee.

GROWTH IN FEDERAL SPENDING IS THE REAL PROBLEM

Mr. Chairman, as you well know, the real problem we are faced with is the growth in Federal spending. Federal spending is the true measure of crowding out of the economy. There has been a great focus on the deficit. Many people think the problem is the deficit. Of course, that is only a symptom of the real problem.

And to make policy on the basis of deficit forecasts, we believe would be very misguided. The deficit forecast of virtually all of the responsible agencies have been notoriously inaccurate

It comes down to the fact that Congress only has three options: One, to increase taxes; two, to increase borrowing; three, to reduce spending. I will argue today that you have no option. If you want to promote those policies that will increase the economic well being of all of our citizens, the only choice we believe you have is to reduce the growth rate of Federal spending.

INCREASING TAXES HAS HARMFUL EFFECTS

Regarding tax increases, there is far more empirical evidence of the harmful effects of increasing taxes than there is of increasing borrowing. When you increase taxes, you always reduce the rate of economic growth and diminish the standard of living of those taxed.

Congress virtually never receives, or the Federal Treasury virtually never receives as much revenue from a tax increase as is projected because of disincentive effects. Tax increases promote the growth of the underground economy. Tax increases penalize people for engaging in productive economic activity. Tax increases reduce the freedom of our citizens to enjoy the fruits of their own labors.

Finally, history shows that Congress tends to increase spending at a more rapid rate than it increases taxes. TEFRA was a prime example of this. Originally we were promised spending cuts of $3 for each dollar of tax increase. The opposite happened. Federal spending actually went up by $1.14 for each dollar of tax increases.

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[1] See p. 484.

INCREASED BORROWING REDUCES THE AMOUNT OF CAPITAL AVAILABLE

The second option is to increase borrowing. Currently, a large deficit is undesirable. It reduces the amount of capital available for private sector investment, and, hence, diminishes our long range capital formation, and real economic growth.

The degree to which Federal borrowing diminishes the amount of investment capital available, of course, is subject to much debate among economists, but it clearly does to some degree.

I have noticed in the press, the comments of Chairman Volcker and others regarding the deficit. They have argued the main reason we want to reduce borrowing is because increases in borrowing increase interest rates. However, I find these arguments at best greatly overstated.

The evidence is most ambiguous, as demonstrated by Treasury studies, and even by CBO studies. In fact, the CBO February 1984 economic outlook report has a summary of the various studies. The results are mixed. Moreover, if you take the most recent studies, you find that only four show that interest rates are positively correlated with increases in the deficit. One shows they are negatively correlated. Six show mixed results. And one shows no relationship at all.

REDUCE THE GROWTH RATE OF FEDERAL SPENDING

Given that, I think it would be a mistake for the Congress to go ahead and base policy on something for which there is little consensus among the economics profession. Hence, if we rule out tax increases as undesirable, if we agree that borrowing increases are undesirable, although probably not as harmful as tax increases, then in order to promote economic growth we have no choice except to reduce the growth rate of Federal spending.

The chamber, the last couple of years, has presented alternative budgets for consideration by the Congress. We have updated those proposals that have been accepted or endorsed by the board of the U.S. Chamber of Commerce.

Let me briefly review these proposals again, and we offer them for your consideration. We would also look at alternatives and try to assist you in any way we could.

Recognizing the absence of any serious spending restraint at the present time, the chamber has again developed an alternative budget. Based on the economic assumptions in the President's budget, we can substantially reduce the deficit without relying on any major tax increase.

MAKE CHANGES IN COST OF LIVING ADJUSTMENTS

Our proposal incorporates the following seven key measures. First, cost of living adjustments for all indexed entitlements and disability programs should be frozen for up to 12 months to correct for past overindexing due to flaws in the CPI. After the freeze, indexing should be limited to 60 percent of the CPI. The 60 percent is the chamber's equity cap COLA and equal to the private sector wage COLA's where such indexing exists.

Our recommendation of a specific COLA change this year reflects three considerations. In our-day-to day contact with our business members, we find that automatic indexing continues to be a major budgetary concern. Members view it as the key to budget controllability.

Congress and the administration have not yet acted on any of the COLA reforms that have been proposed. It should be noted here that many European governments have already reduced or eliminated their automatic COLA's. Our proposal is superior on the grounds of fairness and equity, budget controllability and trust fund solvency to those that have been put forward in the past several years.

In fact, if you study the OMB budget projections, you find that from 1985 to 1989 the social security COLA, alone, will account for $37.4 billion in spending increases. A 1-year COLA freeze with a 60-percent cap would save $20 billion of that $37 billion increase.

LIMIT THE GROWTH OF MEDICARE AND MEDICAID

The growth in Medicare and Medicaid should be limited to the percentage growth in the number of beneficiaries, plus the change in the GNP deflator. This would leave real per capita benefits constant, and provide strong incentives to the Medicare system to contain costs.

Strict limits on Federal medical spending must be adopted now to avoid an explosive growth of outlays after 1990 as the age population swells rapidly. To achieve this objective, Congress should adopt the administration's recommendations, the recommendations of the Grace Commission and the recommendations of the Social Security Advisory Council on Medicare. Such recommendations include increasing the age of eligibility and restucturing the health insurance program.

FREEZE FEDERAL PAYROLL COSTS

Three, total Federal payroll costs should be frozen for 1 year. In subsequent years, total Federal payroll should be limited to 3 percent increase per year; the pay of individual employees could rise by more than this amount to the extent that productivity gains and program reduction allow for reduction in workforce by attrition.

Additionally, the implementation of the Grace Commission reforms would enable Congress to achieve even greater savings this year.

LIMIT OUTLAYS FOR NATIONAL DEFENSE

Outlays for national defense should be limited to 7 percent real growth per annum, as the President requested in 1981. Real growth should be adjusted by the GNP deflator to provide cost containment incentives to the Department of Defense.

REDUCE NONDEFENSE DISCRETIONARY PROGRAMS

Additional reductions should be sought in nondefense discretionary programs. The recommendations of the GAO, CBO, the Grace

Commission and past and present administration budget proposals should provide important sources for savings.

INCLUDE ALL GOVERNMENT AND NONPROFIT WORKERS IN SOCIAL SECURITY SYSTEM

All Government and nonprofit workers should be included in the social security system starting in 1985, rather than the far more limited number that will be included pursuant to the recently enacted social security legislation.

This approach, combined with the COLA cap, will substantially improve the solvency of the system without overburdening existing workers and employers or breaking parity in their payments, and without tapping general revenue.

LIMIT OFF-BUDGET OUTLAYS

Efforts should be made to limit off-budget outlays, including Federal loans and loan guarantees to bring selected off-budget programs on the unified budget, and to enact legislation that would subject the off-budget outlays and commitments to the controls and procedures of the existing budget process.

Based on the President's budget submission, and its economic assumption, our preliminary calculations indicate that these proposals, if enacted, could reduce the unified budget deficits to below $50 billion by fiscal year 1989 using OMB's revenue estimates and base line spending assumptions.

In conclusion, a little more than 3 years ago, the American electorate voted overwhelmingly for a Senate and President that promised to reduce the size of Government. Despite this mandate, and the public opinion polls that show continued support to reduced spending as opposed to tax increases as the way to reduce the deficit, our elected officials have instead enlarged the scope of Government.

Had we simply held the burden of spending at the, then, record share of output that characterized the budget during President Carter's last full year, spending today would be $57 billion lower, and the deficit would not be the problem that most people perceive it to be.

Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you very much.

[The prepared statement of Mr. Rahn follows:]

STATEMENT
on
FY 1985 BUDGET
before the
SENATE BUDGET COMMITTEE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
Richard W. Rahn
February 9, 1984

I am Dr. Richard W. Rahn, Vice President and Chief Economist for the Chamber of Commerce of the United States. On behalf of the Chamber's more than 200,000 business, trade association and local and state chamber members, I welcome this opportunity to present our views on the President's FY 1985 Budget, the trends in federal spending that have contributed to large deficits and to share with you our recommendations for reducing these projected deficits by imposing firmer limits on the growth of government spending.

Summary

The chief causes of federal deficits in our view are rapid growth in government spending and below-average growth in our economy. Effective solutions to this problem are those that impose firm limits on the growth of government spending and preserve and encourage the economic recovery now underway. Anything short of this, and I include tax increases in this category, will be largely ineffective and will likely make the problem worse. While we share your concern abut the future course of projected deficits, we view these projections as a symptom of a larger and more severe problem.

The true measure of "crowding out" by the federal government is the share of our gross national product devoted to the funding of the vast array of federal spending programs. Last fiscal year, this crowding out amounted to 24.7 percent of our gross national product, the highest level ever achieved in peacetime and nearly 20 percent more than the level of intrusion in FY '79. Despite this substantial increase in the degree of crowding out, the policy debate on the budget has persistently focused on the symptom of this problem: the gap between outlays and receipts. Expressed as such, the debate has degenerated into endless quibbling as to the proper mix of borrowing and taxation to fund the spending that Congress imposes on the American people.

But whether Congress chooses to fund this spending by taxing or borrowing, someone, somewhere will be crowded out, and the private economy will suffer accordingly. As I survey the literature on the subject, it is clear that we have more documented evidence on the harmful effects of high taxes than we do on the effects of deficits. Clearly, deficits are a threat to our economy. However, the real threat of the deficit is derived more from the fearful reactions it induces in our policy makers and the actions they might take to resolve the problem than from whatever direct and measurable impact it might have on financial markets and economic activity.

Again this year, in recognition that rapidly rising federal spending is imposing a severe burden on the U.S. economy, the Chamber has developed its own budget proposal and is submitting it to Congress for consideration. Consisting of seven key principles of budget restraint and focusing on those areas of the budget that have grown the fastest, the Chamber's budget proposal, together with the many recommendations of the Grace Commission, will lead to substantial deficit reductions over this decade without relying on any major tax increases or imposing an undue burden upon those who rely on federal benefit programs.

The President's FY 1985 Budget

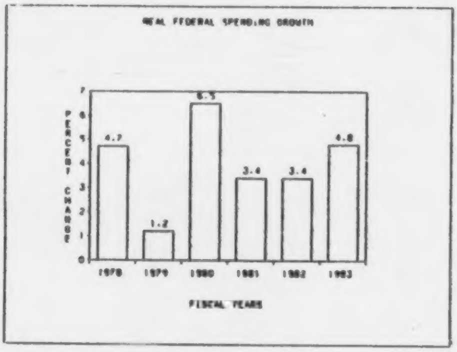
The key feature of this year's budget is the President's resolve to steer clear of major tax increases. This reflects the Administration's desire for economic growth and its recognition of the disincentive effects associated with rising taxation. We applaud this determination to preserve the tax relief granted in 1981. On the spending side, our enthusiasm is somewhat restrained because of the modest efforts to limit spending. In essence, the Administration presents us with something approximating a current services budget — a budget that avoids significant change.

The past year has been one of achievement for the Administration with a real economic growth rate of 3.3%. In large part, this was due to the Administration's ability to fend off those who would make us believe that major tax increases can close the deficits caused by runaway spending. Nevertheless, the President's 1985 budget itself "tiptoes" around the most important expenditure issues — issues that must be confronted if expenditure growth is to be controlled in the 1980s.

The truth of the matter is that expenditures measured in either real or nominal dollars continue to grow. In fact, the real growth of federal expenditures, as illustrated in Table I, continues at rates comparable to the Carter era. From this perspective, it is surprising that some continue to create the fiction that the Administration has engineered "massive" budget cuts. With real government expenditures for FY 1985 projected to grow at

3.3 percent, it stretches the imagination to believe that spending has been cut to the bone.

Table I



Over the last century, public spending has been rising at an annual rate almost 2 to 3 percent faster than the Gross National Product (GNP). While this trend is noteworthy in itself, its ramifications can be shocking. According to some estimates, if we extrapolate the historical trend of federal expenditures into the future, federal expenditures as a percent of GNP will approach 40 percent by the year 2000 and 100 percent by 2036. By this timetable, the actual percentage of federal expenditures for 1984 would be in the neighborhood of 24 percent, which means that the FY 1983 share of 24.7 percent was ahead of schedule!

A closer look at the President's 1985 budget reveals its status quo nature. The projected $925 billion expenditure level is only $19 billion less than the current services estimate — an estimate of outlays that assumes no policy changes from the previous year. This "don't rock the boat" strategy is disturbing because it passes up beckoning opportunities for serious spending restraint. Moreover, as Table II shows, the majority of the

Table II
Differences Between Current Services and the Budget:
Outlays by Function, 1985
(In billions of dollars)

	1985	Difference as a % of Current Services Budget
Current services estimates	944.9	-4.3%
Differences:		
National defense	-12.2	
International affairs	3.4	+24%
General science, space & technology	.4	+4.0%
Energy	-.2	-5.8%
Natural resources & environment	-.5	-4.2%
Agriculture	- *	0
Commerce and housing credit	-.4	-25%
Transportation	-.4	-1.5%
Community and regional development	-.1	-1.2%
Education, training employment & social services	-1.1	-3.7%
Health	-1.5	
Social security & medicare:		
Social security	-.1	
Medicare	-1.0	
Total Social Security & Medicare	-1.1	-.4%
Income security:		
General retirement & disability insurance	-.2	
Federal employee retirement	-.7	
Unemployment compensation	*	
Housing assistance	-.1	
Food and nutrition assistance	-.6	
Other income security	-.9	
Total income security	-2.5	-2%
Veterans benefits and services	.1	.3%
Administration of justice	- *	
General government	*	
General purpose fiscal assistance	-.1	-1.4%
Net interest	-1.8	-1.5%
Allowances	-.5	
Undistributed offsetting receipts	-.7	
Total differences	-19.4	
Total budget outlays	925.5	

* $50 million or less

proposed "baseline" savings, approximately $12 billion, come from defense spending. However, there is good reason to doubt even these savings since Congress has often challenged the Administration's baseline military estimates. For example, using Congressional Budget Office (CBO) baseline numbers, such savings are more in the order of $6 billion -- a discrepancy of 50 percent.

Turning to other areas of the budget, "savings" from the baseline estimate amount to little more than $6 billion. This modest sum comes from a vast area of the budget that offers substantial opportunities for further savings.

The Deficit is a Symptom of a Larger Problem

The federal budget has become a topic of grave concern, and, the budget deficit, to an even larger extent, has been singled out by some as a leading cause of our economic ills. For many, the deficit has taken on a character of its own -- breathing terror across the landscape. There is no doubt that the deficit is a problem of national concern. However, let us place it in its proper context. The crux of the matter is that the root of our fiscal problems is not, as some try to make it, the deficit per se, but rather the level of government expenditure.

All too often this fixation over the deficit obliterates the really critical issue: reducing excessive government. Many who seize upon the deficit issue make it appear that simply raising taxes will cure our fiscal problems. However, we should be painfully aware by now that increased taxation is associated with devastating disincentive effects of its own. The fact remains that the real cost of government is the level of government spending itself.

While the level of government expenditure would seem to be the looming issue, for many this is not the case. Instead, the deficit debate focuses on the merits of higher taxation versus less "crowding out." This discussion makes it appear as if a mere substitution of one method of finance for another will result in gains to the economy. However, there is no escaping the fact that each method of finance extracts its price from the public. We must constantly remind ourselves that the deficit is a symptom of a larger problem: runaway expenditures. This is a problem that will not go away with higher taxes. You simply do not change the habits of an extravagant spender by providing him with more funds. Nonetheless, the notion that the deficit is an evil in and of itself now characterizes all public debate to the exclusion of everything else.

Over the past several years, the economics profession has carefully inspected this claim. These results are well summarized in a recent study by the U.S. Treasury Department. In this comprehensive report, Treasury investigates the relationship between deficits and interest rates. Contrary to popular opinion, they find that this relationship is clouded with ambiguity. The report maintains that interest rates are determined by a number of other important factors such as the level of government expenditures, the disincentive effects of taxation, the time horizon and money supply policies. The report cites empirical work that suggests interest rates are correlated with the level of government expenditures rather than the deficit per se. This supports the idea that the focus on deficits often blurs the most critical issue -- this being control over expenditure growth. Consequently, reduction of interest rates may have more to do with budget discipline than with, for example, increased taxation.

What does this research mean for public policy? It means that the scenario of the tax increasers is seriously in doubt. Their argument is that raising taxes will lower interest rates, promote economic recovery, generate growth, and lower inflation. In fact, according to the Treasury report, the opposite is just as likely. This occurs because increased taxation carries along with it smaller disposable income, reduced incentives for work and savings, more underground activity, and less fiscal discipline. This adds up to less economic growth, a smaller tax base and few if any reductions of long run interest rates. Moreover, higher taxation, such as repeal of indexation, would increase the temptation for bracket creep and a return to inflationary monetary policy.

Tax Increases: Ineffective and Counterproductive

Despite mounting evidence that spending is the problem, many in Congress and the Administration continue to adhere to the belief that a substantial tax increase is the cornerstone of an effective deficit reduction package. Last year, many of these same individuals predicted that, without a major tax increase, we could not achieve a vigorous economic expansion. Consequently, their forecasts for economic growth for 1983 were generally pessimistic. The President's own Council of Economic Advisers, for example, projected a real economic growth rate of 1.4 percent for 1983. On the basis of such forecasts, the clamor for tax increases rose. We were told that such a package was needed to restore economic growth and close the deficit. The same argument continues to be trumpeted today.

In stark contrast, the Chamber insisted that tax increases would jeopardize the recovery, reduce the tax base, and increase the deficit. We continued to believe in the President's original program for economic recovery and tax relief. The record speaks for itself. The President did not raise taxes at the behest of Congress and some of his own advisers. The recovery was much greater than expected. In fact, the Chamber's forecast of economic growth reflected the President's resolve. We predicted a growth rate of 3.2 percent; the actual growth rate was 3.3 percent. This was the most accurate forecast as measured by "Blue Chip Indicators", a monthly survey of approximately fifty major economic forecasts, including the major econometric models.

The message is clear. A basic prerequisite for a viable economy is a healthy incentive structure. It is an economic system that rewards some of man's most noble ventures: work, creativity, savings and investment. This cannot be achieved with a budget policy that feeds runaway spending by putting the pinch on American workers and businesses through rising taxation.

It is important to realize that massive tax increases will not reduce the deficit and may even worsen it by diminishing economic growth. All too often, the logic behind the tax increase strategy is based on an accounting perspective of tax revenue. Simply put, tax revenues expand by the increase of the tax rate multiplied against the existing tax base. However, this static estimate of tax revenues fails to take into consideration the disincentive effects of higher tax rates upon the tax base. Specifically, rising tax rates mean less economic growth. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) illustrates this point. When it was enacted, TEFRA, in conjunction with the modest spending decreases included in the reconciliation bill, promised a $103.9 billion deficit in FY 1983 and an $83.9 billion deficit in 1984. These targets, of ourse, were never achieved. Revenues failed to rise and spending exceeded targets by a substantial margin: $26 billion in FY 1983 and a projected $32 billion in FY 1984.

TEFRA failed to achieve its objective. Not only did the deficit fail to decline; it more than doubled from what had been projected. Although it did not even come close to achieving its targets, it did leave a trail of damage that will be with us for some time. TEFRA was promoted as a "loophole closing" measure, but it had a severe impact on business. Nearly 60 percent of the revenue came from cutbacks on business, and these changes eliminated more than 70 percent of the reductions business received in the 1981 Act. Investment was especially hard hit through changes in the Accelerated Cost Recovery System (ACRS). Changes in the pension area through the "top-heavy" rules added to the cost of compliance and have induced small firms to terminate pension plans. The financial industry has wasted millions of dollars on unneeded withholding schemes. Worse than this, however, federal spending continued to expand, continued to crowd out the private economy, and remains, as a consequence of this neglect, a more difficult problem to resolve than it was two years ago.

Unfortunately, TEFRA was not the only major tax increase inflicted on our nation over the past year or two. Despite the well-documented evidence that payroll taxes have a substantial negative effect on employment, economic growth and overall government revenues, an increase in payroll taxes was key to recent Social Security legislation that was largely dependent upon tax increases as the solution to the solvency problem. As far back as 1978, the Congressional Budget Office (CBO) warned that a half a million lost jobs would result from the 1977 legislation that raised payroll taxes in an earlier failed effort to restore solvency to the Social Security system. In part, the record unemployment that occurred during the recession was attributable to this. In addition, as in the case with TEFRA, these payroll tax increases fell well short of restoring solvency to the system.

As part of the Social Security compromise, future payroll tax increases were included in the 1983 Act, despite projections made by the leading economic forecasting firms that a payroll tax increase would substantially diminish employment and economic growth. Simulations by Data Resources Inc., Wharton Econometrics, the Congressional Research Service and the U.S. Chamber found that the employment loss during the remainder of this decade could range from 300,000 to 4.1 million jobs, depending on how much the tax was increased.

With this as a prologue, last year the budget committees responded to the large projected deficits by proposing tax increases in excess of $250 billion over the next five years. Fortunately, Congress had the good sense to reject these proposals by settling on a somewhat less harmful budget resolution that included tax increases of $73 billion over three years. And, consistent with recent trends on spending, the reconciliation instructions accompanying the budget included a meager spending reduction of $12.3 billion over the next three years. Had it passed, this spending restraint would have reduced the projected deficit by 2.3 percent.

What Can Be Done to Reduce the Deficit?

Although the rapidly expanding economy will narrow the deficit at a faster pace than most forecasters now project, severe crowding out will persist as the federal government continues to absorb more than 24 percent of our Nation's output. The only way to resolve this problem is to limit federal spending growth by imposing firm restraints on those programs that are responsible for the rapid growth we have experienced over the past many years.

In an effort to achieve this objective, the President, in his State of the Union Address on January 25, 1984, announced his intention to convene a meeting of representives of Congress and his administration to try to reach prompt agreement on a bipartisan deficit reduction plan. He expressed his belief that an agreement among the participants could lead to deficit reductions of $100 billion over the next three years and noted that the work of the Grace Commission could serve as the basis for these savings.

We concur with this final point and urge Congress to consider, as its highest priority, the more than two thousand recomendations made by the President's Private Sector Survey on Cost Control. Indeed, if only one-fourth of the Grace Commission's identified savings were achieved, Congress would exceed the President's request for a downpayment against the deficit projections that many find so alarming. While some have questioned the accuracy and assumptions that went into the Commission's savings estimates, it is our belief, based on the many similar studies of the same programs performed by the Congressional Budget Office and the General Accounting Office, that substantial outlay savings can be made in the problem areas identified by the Grace Commission. The Chamber encourages Congress to implement as many of the Grace Commission recommendations as possible in this session.

The Commission's findings and recommendations on federal compensation are a case in point. These recommendations, which account for one-eighth of the Commission's total proposed savings, are not unlike the recommendations made on federal pay and pensions by numerous other commissions, private studies and analyses by the OMB, CBO and GAO. Last year, for example, the President's budget included several proposed requests to restrain spending by modifying the federal pay and pension system. Most of these requests were rejected by Congress. Given Congress' concern over the deficit projections, we strongly encourage you to reconsider these proposals.

In addition to the many recommendations of the Grace Commission, we also urge you to give serious consideration to the budgetary proposals developed by the Chamber. Last year, recognizing that neither Congress nor the Administration was inclined to propose a budget that placed firm limits on spending growth, the U.S. Chamber took the unprecedented step of developing its own budget for Congress to consider. Although it garnered the support of most of the business community by the time a modified version of it was finally bought to the floor of the Senate for a vote, few, if any, of its proposals were enacted.

Recognizing the absence of any serious spending restraint proposals at the present time, the Chamber has again developed an alternative budget. Based on the economic assumptions in the President's budget, it can substantially reduce the deficit without relying on any major tax increase. Our proposal incorporates the following seven key measures of spending restraint.

1. Cost of Living Adjustments (COLAs) for all indexed entitlements and disability programs should be frozen for up to twelve months to correct for past overindexing due to flaws in the Consumer Price Index (CPI). After the freeze, indexing should be limited to 60 percent of the CPI. The 60 percent is the Chamber's "equity cap" COLA and is equal to private sector wage COLAs

where such indexing exists.

Our recommendation of a specific COLA change this year reflects three considerations: A) In our day-to-day contact with our business members, we find that automatic indexing continues to be a major budgetary concern. Members view it as a key to budget controllability. B) Congress and the Administration have not yet acted on any of the COLA reforms that have been proposed. It should be noted here that many European governments have already reduced or eliminated their automatic COLAs. C) Our proposal is superior on the grounds of fairness and equity, budget controllability, and trust fund solvency, to those that have been put forward in the past several years.

2. The growth in Medicare and Medicaid should be limited to the percentage growth in the number of beneficiaries plus the change in the GNP deflator. This would leave real, per capita benefits constant and provide strong incentives to the medicare system to contain costs. Strict limits on federal medical care spending must be adopted now to avoid an explosive growth in outlays after 1990 as the aged population swells rapidly. To achieve this objective, Congress should adopt the Administration's recommendations from this and previous budgets, the recommendations of the Grace Commission and the recommendations from the Social Security Advisory Council on Medicare such as gradually increasing the age of eligibility and restructuring the Health Insurance Program.

3. Total federal payroll costs should be frozen for one year. In subsequent years, total federal payroll should be limited to a three percent increase per year. Pay of individual employees could rise by more than this, however, to the extent that productivity gains and program reduction allow for

reduction in workforce by attrition. Additionally, the implementation of Grace Commission reforms would enable Congress to achieve even greater savings in this area.

4. Outlays for national defense should be limited to seven percent real growth per annum, as the President requested in 1981. Real growth should be measured as deflated by the GNP deflator to provide cost containment incentives to the Department of Defense.

5. Additional reductions should be sought in nondefense discretionary programs. The recommendations of the GAO, the CBO, the Grace Commission, and past and present Administration budget proposals should be given serious consideration as sources of savings.

6. All government and nonprofit workers should be included in the Social Security sytem starting in 1985, rather than the far more limited number that will be included pursuant to the recently enacted Social Security legislation. This approach, combined with the COLA cap, will substantially improve the solvency of the system without overburdening existing workers and employers, or breaking parity in their payments, and without tapping general revenues.

7. Efforts should be made to limit off-budget outlays, including federal loans and loan guarantees, to bring selected off-budget programs on the unified budget and to enact legislation that would subject the off-budget outlays and commitments to the controls and procedures of the existing budget process.

Based on the President's budget submission and its economic assumptions, our preliminary calculations indicate that these proposals, if enacted, could reduce the unified budget deficit to below $50 billion by FY 1989 using OMB's revenue estimates and baseline spending assumptions.

Conclusion

A little more than three years ago, the American electorate voted overwhelmingly for a Senate and President that promised to reduce the size of government. Despite this mandate and the public opinion polls that continue to show that the American people prefer spending restraint to tax increases as the way to reduce the deficit, our elected officials have instead enlarged the scope of government. Had we simply held the burden of spending at the then record share of output that characterized the budget during President Carter's last full fiscal year, spending today would be $57 billion lower, and the deficit would not be the problem that most people perceive it to be.

Chairman **Domenici**. Senator Exon, I understand Senator Chiles is going to be detained and may not make it. We're going to finish here at 3, I think. Did you want to make any remarks?

Senator **Exon**. No, let's just go and proceed, and I may have some questions, Mr. Chairman.

Chairman **Domenici**. All right. Mr. Sommers, senior vice president and chief economist for the Conference Board, will you proceed please?

STATEMENT OF ALBERT T. SOMMERS, SENIOR VICE PRESIDENT AND CHIEF ECONOMIST, THE CONFERENCE BOARD

Mr. **Sommers**. Thank you, Mr. Chairman.

The ultimate burden of my testimony is to offer a sense of urgency about the budget dilemma that we are in. For that reason, it may be relevant for me to note that my history is not that of an alarmist on budget deficits by any means. In fact, I consider budget deficits not inherently abnormal. I don't believe that a Federal Government should be under any constraints with respect to enlarging its aggregate debt any more than any other sector.

The historical record reveals a parallel increase of public and private debt taken together, along with the rise in the GNP. I think our history on budget deficits and on the Federal debt treated as an accumulation of ongoing annual deficits is not abnormal or alarming.

We started the post-war years with the Federal debt equal to close to 100 percent of GNP. It was down to 40 percent by the middle 1970's, and depending on which debt figures you use, somewhat lower than that toward the close of that decade.

RELATIONSHIP OF FEDERAL DEBT TO GNP ENGAGED IN DANGEROUS CHANGE

The relationship of the Federal debt to the GNP is becoming an increasingly popular way within the profession to try to grasp the Federal debt in a relative sense, as we try to do with all other figures, making due allowance for the growth of the system to which the debt applies.

The history of that relationship shows, in addition to a long down trend in the post-war years, a natural cyclical fluctuation. In bad years, the GNP doesn't rise very much; the revenues of the Federal Government don't rise, or decline. The debt rises, and the relationship rises.

In the ensuing expansions, throughout the post-war years, that process has reversed, and the debt-GNP relationship has declined.

I think most economists would be willing to accept that mechanism as a part of the stabilization efforts that we and all modern economies have undertaken.

But it is true that, as nonalarmist as I can be about the historical record, I do carry an alarm about the present and the future. We are engaged in a dangerous change in that relationship. If we simply pursue the course outlined in the Federal budget, much less outlined in the CBO report, the relationship has been in a strong continuing rise since 1982. In 1983 it was higher than at any time in the past 15 years. In 1984 and 1985 it will be higher than at any time in the past 25 years.

It's this sense that this relationship is rising so rapidly that underlies the propositions crowding out. If the relationship of aggregate debt to GNP is constant, or relatively constant, the rise in the share of debt taken by the Federal Government must be accompanied by a decline in the share taken by the private sector.

In the bidding to arrange those shares in a capital market, of course, the interest rates will rise; it will be the private sector that will be priced out, since the Federal Government is inherently a non-interest-sensitive borrower. The financial markets will experience severe tension and difficulty. The declines in the markets will distribute capital losses widely. A recession is not an unreasonable expectation in the light of those developments. And of course under recession, the deficit will get still bigger and be more difficult to control.

This is the normal way of stating tbe danger posed by the deficit trajectory we're looking at. But it has to be borne in mind that that reasoning treats the U.S. economy as a closed system unconnected to the financial markets around the world. That was always a very artificial assumption; it is utterly ridiculous now. We all live in one financial community. You can run money out of Nepal with one banker and a desk. I'm not even sure you need a bank. You need a phone.

CROWDING IN PHENOMENON BEING EXPERIENCED

This is not a world in which we can any longer view our problem as isolated from the real and financial markets around us. The point is very relevant now, because while we are not visibly experiencing crowding out, we are experiencing a phenomenon that could be called crowding in.

Now, let me offer you a description of that phenomenon. The budget deficit and its anticipated trajectory is the upstream source of a series of consequences that runs as follows: From the deficit, to high interest rates; from high interest rates to a high valuation of the dollar; from a high valuation of the dollar to a trade deficit that is actually awesome.

A little paradoxically, while the trade deficit distributes dollars all over the world in settlement, and ordinarily currency in that abundance would weaken, the very high interest rates we are experiencing on account of the deficit makes dollar-denominated investments very attractive, and all the dollars we distribute abroad as a consequence of settling our current account deficit return to us as an inflow of capital.

If we had not experienced crowding out in that earlier domestic context thus far, it is partly because foreigners have been providing us with a large and growing margin of international capital.

There are three reasons why they are willing to put their capital here. The first is we are a haven; the safety quality of the dollar and of our economy is certainly very important.

Second, the high interest rates provide a yield better than can be gotten anywhere else, even better than can be gotten by direct investment in Europe. So a European businessman finds investing in dollar denominated assets really more beneficial than investing in the ground in his own country.

The third reason is that after a prolonged rise in the dollar, in a market as gigantic as the dollar market abroad, which is a vast multiple of our own dollar money supply here, we would be very unwise not to recognize that there is a substantial speculative element in investment in the United States.

RETURN FLOW OF DOLLARS DIFFICULT TO MEASURE

Now, how big the flow is, is very difficult to measure.

Chairman DOMENICI. You mean the flow in?

Mr. SOMMERS. The flow in. The return flow of dollars. Mr. Volcker, the day before yesterday, used $40 billion as an estimate for 1983 and $80 billion as an estimate for 1984.

I suspect while his level of ignorance on the numbers is, I'm sure, far less than mine, those numbers sound as though he is simply assuming that what goes out this year will come in next year, without regard to the fact that there is an immense supply of dollars over there that can come over here independently of our current account deficit.

In any event, foreigners are making a massive addition to the U.S. savings flow. By so doing, they are masking and disguising what might well be crowding out even now. But we don't control that flow. The Federal Reserve doesn't control that flow. A lot of it isn't part of our money supply, and the danger of it stopping, and the greater danger of its reversal, I think, are very real.

We are growing increasingly dependent on foreign-owned capital to finance our aggregate capital market, including, of course, the financing of our deficit.

To put it another way, the interest rates we are experiencing now are simply not high enough to generate the volume of domestic capital to meet the needs in our capital market given the size of the deficit.

You know, this is a little irreverent, but you might almost wonder how the IMF would feel about this behavior if we were in the position of having to go there and borrow. We're running a historic trade deficit and a huge budget deficit. They might well ask us to put our house in order as they're asking everybody else.

Anyway, the sense of urgency that I offer you comes out of this issue, because the timing of it I consider very treacherous. Crowding out is a process that we can observe visibly. It would have little speculative momentum to it. We can see it coming and try to do something about it.

This one is much more difficult. We can't see it coming. It may be happening even now. The weakness of the dollar is doubtless playing some role in what's happened to our equity market because it's a very good bet that foreigners are sellers of U.S. equities under present conditions.

So, if we defer action until 1985, we may be able for a while to congratulate ourselves on the fact that the evidences of crowding out have not appeared; but I think we're on the edge of a precipice with respect to the willingness of the rest of the world to continue to finance this kind of behavior.

LET THE WORLD KNOW OUR INTENTIONS

So, I offer you an argument that we had better get about this business and let the world know that our intentions are to shrink our capital demands back towards the levels we are willing to raise domestically.

In order to do that, I think we need three accords. This is a big order—but then, this committee must be accustomed to fairly big orders by now. The first is an agreement between the administration and the Congress to cut the deficit I would say by not less than $75 billion by fiscal year 1986, with a large part of that achieved by fiscal year 1985.

Second, I think the Congress and the administration together, having reached that accord should seek agreement with the Federal Reserve to subordinate its inflation criteria to the provision of credit for the U.S. economy in the course of this transition back toward a more normal posture.

Chairman DOMENICI. What does that mean?

Mr. SOMMERS. What it means is that the Federal Reserve's attention to the money stock should be sophisticated, as it was over the past year, by recognition of the dilemma that the economy as a whole is confronting.

Chairman DOMENICI. So if we make this good faith effort, they ought to understand we can't do much better? Is that what you're saying?

Mr. SOMMERS. Well, hoping that you do well enough to induce the Federal Reserve to agree that this is an honest effort with a big future, that it can adjust its own criteria of behavior in an accommodative way, to meet our needs in the event that we experience withdrawals of foreign capital.

Finally, I think we need agreements, cordial, possibly explicit relations with our trading partners to cooperate in an orderly decline of the dollar. Not to be massive investors in the dollar, but to behave in ways that will permit a gradual and nonspeculative withdrawal of the dollar, rather than a sharp and very disturbing withdrawal.

With those three pieces put in place, I think the American economy can get back on a path toward considerably lower deficits, lower interest rates, a lower dollar, and a lower trade deficit with the rest of the world. And in my view, those are urgently needed. Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you very much.

[The prepared statement of Mr. Sommers follows:]

THE SIGNIFICANCE OF THE BUDGET DEFICIT

Testimony before the

U.S. Senate Committee on the Budget

U.S. Senate

Washington, D.C.
February 9, 1984

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The Conference Board
New York, New York

I am grateful for this opportunity to offer the Committee my views on the federal budget and deficit issue, with particular reference to the causes and consequences of the deficit, and what kinds of actions are desirable to reduce the consequences. Most of my views are, I believe, very widely shared among practicing economists; the material on the international complications surrounding the deficit may be less widely shared, but I believe them to be powerfully important, and perhaps determining. I am enclosing copies of two issues of a Letter I write for subscribers in the United States and in Europe; they provide elaboration on the international aspects of the budget deficit and its consequences.

Since I take a concerned view of the prospect for budget deficits over the next several years, it may be desirable to start off by saying that there is most certainly a place for budget deficits in the real world. No sector of the U.S. business system --- the household sector, the business sector, the government sector --- "lives within its income." Aggregate debt (public and private) necessarily grows along with the economy itself, and the income flows from which the debt is serviced. There has been a long and stable historical relationship of aggregate public and private debt to the gross national product. The federal component of aggregate debt declined rapidly as a percentage of GNP in the two decades following the end of World War II, and then more slowly from the middle 1960's to the early 1970's; these were periods of progressive digestion of the huge public debt resulting from the financing of World War II, and the gradual maturing of private debt as the immense private liquidity constructed in World War II was absorbed by rising output, and the rise in the price level. Despite the clamor over public deficits in the United States, the aggregate experience was by no means alarming, and by no means evidence of improvident use of the federal government for stimulative purposes. This does not mean that the dollars of government outlay went exactly where anyone would have wished, or that the relative size of government and the tax structure that collected the revenues were ideal in any practical or philosophical sense; but the deficit experience itself has not until recently been a matter of genuine alarm.

Expressed both in dollars and as a percentage of GNP, the deficit experiences the business cycle, in exaggerated form. Characteristically, the deficit widens rapidly during recession, as a function of increasing counter-cyclical efforts by government at a time of falling government revenues; in ensuing recoveries, the deficit has subsided as revenues have accelerated. No one should be surprised at this cyclical behavior, which is generally regarded to be an element of stability in the system, helping to moderate both recessions and expansions. This was the experience during the 1970's, when the relationship of aggregate public debt to gross national product fluctuated cyclically, without a long-term trend, in spite of explosively cyclical behavior in the U.S. price level (largely related to explosions in energy costs).

The budget deficit of 1982 was certainly very big, but it was not inherently destabilizing, and it did not drive the relationship of public debt to GNP beyond levels that prevailed during much of the 1970's. Together with accommodative monetary policy, the deficit of 1982 constituted a shock treatment for a deeply underutilized economy, and helped to install the remarkably vigorous business recovery of 1983.

But the failure of the deficit gap to decline cyclically in 1983, and the prospect that it will remain at levels appropriate only to deep recession throughout the next several years, constitutes a dramatic and serious departure form past management of the budget itself, and of the federal debt. What was a cyclical rise in the relationship of federal debt to the gross national product is being converted to a long-term renewed uptrend in the relationship, bringing it, even by the end of 1983, to the highest level in fifteen years. The uptrend in the relationship will certainly continue in 1984; the net federal debt is likely to rise at a 15 percent annual rate, perhaps double the probable growth rate of the GNP itself. By the end of 1984, this relative measure of the federal debt will be higher than at any time in the past twenty years. And, of course, the Administration's budget suggests still further rises in the ensuing two years. Inevitably, the servicing cost of the debt has been in a dramatic ascent, attributable both to the increase in dollar volume of the debt, and the higher applicable interest rates (which themselves reflect, in some degree, the rise in the debt itself). The relative service cost of the debt is already far, far higher than in any time in the postwar years. It levelled off during 1983, because of stable interest rates and a rapid cyclical recovery; but it will doubtless be rising again in 1984 as the debt grows, and as cyclical recovery subsides to a slower sustainable rate.

In its purely domestic context, the very large size of the deficit, its rapid relative growth, and its continuance at levels that would be justified only under conditions of cyclical recession inevitably raise the issue of "crowding-out." I would guess that the Committee has heard all it has to hear on the threat of "crowding-out," or the alternative threat of rapid creation of credit by the Federal Reserve to finance the combined requirements of government and the private sector in the late stages of a business-cycle expansion. And it has probably heard more than it needs to, on the argument that if the Federal Reserve were to behave in such a way, the real or implied inflation would produce higher interest rates in any event. The Administration itself is evidently not counting on the Federal Reserve to behave in such a way, and the Federal Reserve itself gives every indication that it would not do so.

But the continuance of a high deficit under present conditions raises another problem, which seems to me to be nearer in time, and on the whole more dangerous, than the threat of "crowding-out." This danger might be called "crowding-in." The danger results from a very special set of circumstances. The United States recovery is far faster than among any of its trading partners, which conduces to a trade deficit. At the same time, high interest rates associated with the budget deficit have kept the dollar strong, and invite dollar investment in the United States from all over the world. The United States is experiencing an altogether enormous capital inflow, partly because the dollar is a haven currency, partly because the yield on dollar-denominated investments is so high, and partly because the record of the exchange value of the dollar over the past year has been such as to invite currency speculation in the dollar itself. (Even less speculative reasons for investing in dollar-denominated assets are augmented by prospects for a strong dollar.) The speculation is facilitated by a gigantic, unregulated unsupervised international market in currencies, now regularly handling volumes of dollar transactions that are a vast multiple of the United States GNP.

This capital inflow finds its way of course, into U.S. capital markets, augmenting the available supply; and some of it finds its way into the Treasury securities that finance the deficit. Increasingly in 1983, the private expansion in the United States, in the presence of the immense credit demands of the Treasury, was being financed by foreigners. The structure of policy now prevailing in the United States --- powerfully stimulative public deficits, offset by restrictive monetary policy and elevated interest rates --- is compatible with economic growth only so long as it draws capital from the rest of the world; the policies constrain the domestic supply of saving, and require supplementation from outside.

The growing presence of foreign capital in U.S. markets poses a problem that will increase in intensity as it progresses. If, at any point and for any reason, prospects for the dollar should turn more cautionary, mixed or negative, the inflow of foreign capital might well abate, or conceivably reverse. The United States would then have to fully supply its own capital markets, where the demand is still swollen by the requirements of the Treasury. And if this situation should develop in the late stages of a business expansion, when private demand for capital is rising, the result could be highly unstable conditions in both U.S. interest rates and in the exchange market for the dollar.

This unstable condition seems to call for a shrinkage in the budget deficit,the effects to be offset by an accompanying decline in interest rates --- a move from a "lopsided" disbalance of fiscal and monetary policy toward a more normal relationship. In a few tidy words, what we need is a "mid-course correction." But the logic of the "mid-course correction" rests on an inherently imperfect analogy; depending on it is risky even assuming we could achieve it, and it gets riskier every day. The analogy is drawn from a change in the course of an object in space --- a guided projectile, a missile. But the U.S. economy is not a projectile; it is not a rigid object, whose parts are welded into a fixed relationship with each other, regardless of the course of the aggregate. On the contrary, the parts are free to move, to adapt their relations with each other as the course changes. Moreover, projectiles and spaceships do not develop anticipatory behavior based on their current course; and they do not maintain complicated, changing relationships with other projectiles in the neighborhood. The U.S. recovery inspired by the huge budget deficit and the rapid growth of money a year ago (taken together, the Keynesian shock that set the trajectory of economic recovery) has radically altered the composition of American economic activity; it has driven the stock market into one of its major moves of history; it has produced a huge and growing inflow of imports; and it is drawing heavily on the fuel reserves (dollars) of the rest of the world. The U.S. economy itself, its financial market, and its trade and financial relationships with its trading partners have all shaped themselves around the U.S. budgetary condition, and the economic conditions that flow from it. After a year on the course dictated by the Keynesian shock of late 1982, a "mid-course correction" may have very complicated consequences.

I conclude that the outlook for the United States in the presence of this structure of policy is already cautionary, and grows more cautionary every day. The economic outlook for 1985 is growing progressively more clouded --- a conclusion that the U.S. equity market (and the foreigners who are invested in it) are beginning to appraise for themselves. It is too late to avoid considerable repercussions that would accompany a readjustment in the policies, because so much of U.S. industrial and financial markets have adapted to the existing structure. But the sooner the structure is adjusted, the less the reactions are likely to be. If we were to wait until actual "crowding-out" were to be visible and measurable in the capital markets, the dependence on foreign inflows would by then be all the greater, and the danger of an unwinding of the "crowding-in" would also be vastly greater. Accordingly, we would be very wise to take a large and credible step toward adjusting the policies now, with credible commitments to go further in the future.

Extricating the system from its present distorted condition would seem to require several policy "accords" --- some large and widely shared decision-making: (1) an accord between the Administration and the Congress, producing spending constraints and tax increases whose combined effect on the deficit in fiscal 1986 would be about $75 billion; (2) an accord between the Federal Reserve and the Congress, to subordinate anti-inflation objectives to the maintenance of adequate supplies of credit while the fiscal adjustment is in progress; and (3) an accord with central banks of our trading partners to seek to maintain orderly currency markets (to limit speculation) in a period when U.S. interest rates are likely to be falling, relative to the rates that prevail in other countries. Under such conditions, the U.S. economy is hardly likely to grow much, but it would be making progressive adjustments in its budget deficits and its interest rates, while encouraging an orderly and gradual decline in the exchange value of the dollar.

A very large order, I agree, but a necessary escape from a policy structure that nobody intended --- a structure whose benefits have been largely used up over the past eighteen months, and whose heavy associated costs now confront us.

REAL INTEREST RATES

Chairman **Domenici**. Let me start with you, Mr. Sommers. I have two questions and then I will yield to Senator Exon.

First, looking at the overall American problem and world economic problem that exists today, are interest rates, real interest rates in the United States too high?

Mr. **Sommers**. Yes, they are.

Chairman **Domenici**. So we ought to try to lower them, right? We ought to do what we can to bring them down?

Mr. **Sommers**. We ought to, yes, sir.

Chairman **Domenici**. Do you agree that the real interest rates which are too high are significantly impacted by the present and future deficits?

Mr. **Sommers**. Unquestionably. There are other contributing factors, but the size of the deficit and the prospects for the future are major elements

Chairman **Domenici**. Do you agree that we have only one way to reduce the deficits and maintain the probability of improvement, and that is to cut the budget on the expenditure side?

Mr. **Sommers**. I do not, sir. I don't see a probability of achieving that objective without tax increases. And I must admit that I am not all that sure of the desirability of doing it that way.

Chairman **Domenici**. Only one way, you mean.

Mr. **Sommers**. Of attempting to do it only on the spending side of the budget.

Chairman **Domenici**. All right. I want to ask the same question of each of you. Let me go to Dr. Rahn. Would you answer the same questions?

Mr. **Rahn**. OK. In terms of the real rate of interest. Is that the question?

Chairman **Domenici**. Yes, sir.

Mr. **Rahn**. Well, you always like lower real rates of interest rather than higher, but I have here the new report of the OECD. They claim the real U.S. rate of interest is 3.8 percent as compared to 4.6 percent in the United Kingdom; 3 percent in Germany, 3 percent in Italy, 4.3 percent in Canada, and 5 percent in Japan. And on the basis of international comparison I cannot say our real rate of interest is unduly high.

Chairman **Domenici**. So from our standpoint we have been operating on the assumption has been that we ought to do things to reduce significantly the real rate of interest as a matter of fiscal policy of the country.

Are you suggesting we're wrong?

REDUCING THE VALUE OF THE DOLLAR WOULD BE REGRETTABLE

Mr. **Rahn**. I don't think that ought to be your target objective. Real rates of growth ought to be your target objective. And there was one other thing where I disagree with Mr. Sommers. And that was on the notion of reducing the value of the dollar, of taking direct action to do that.

I think you would regret that action and I go back to the 1977–78 period where we attempted to do that. We brought down the value of the dollar, but what we did was import inflation at the same time.

The high value of the dollar has some benefits. It hurts exporters, of course. But it does make the price of foreign goods much lower, which benefits our citizens.

Chairman **DOMENICI**. I understand. Let's let you finish that shortly if Senator Exon wants to ask it. If not, I'll let you finish that thought.

Mr. **RAHN**. All right. That's the essence of it.

Chairman **DOMENICI**. But let me finish this with all three of you so I can yield to him as I told him I would.

You've already told us that you think the only course of action that's prudent is to reduce the deficits on the expenditure side, so you and he disagree on that.

Mr. **RAHN**. That is right.

DEFICITS AFFECT REAL INTEREST RATES

Chairman **DOMENICI**. You don't have to answer that because you did so in your testimony. If the rate of interest, the real rate is too high, you're not sure it is, but if it is, is it substantially affected by the deficits or not?

Mr. **RAHN**. Clearly it is affected somewhat by the deficits, but I think it's more affected by the instability of Federal Reserve policy and the fact that we do not now know what Federal Reserve policy is. That adds an element of risk which is reflected in higher real rates of interest in the financial markets.

Chairman **DOMENICI**. Mr. Kilpatrick, would you answer the same questions?

Mr. **KILPATRICK**. Yes, Mr. Chairman. Mr. Chairman, in my view the deficits absorb savings, and they drive interest rates up. I think that unless decisive action is taken, interest rates will go even higher than they are now in the years ahead. That will continue the overvalued situation of the dollar which will threaten more than ever our export industries. Trade deficits will grow. It's a never ending spiral.

I think we have to take decisive action to reduce the deficit. Now, can the deficit be solved solely by spending reductions? I would emphatically say I do not think it can.

On the other hand, I would urge in the strongest terms that Congress address the spending side as its higher priority. If that is done, I think you will then find the business community that I represent would be more supportive of revenue increases of sufficient magnitude.

But I would emphasize again, Mr. Chairman, that unless entitlement programs are dealt with, I do not believe you can raise taxes high enough to do any more than simply prolong the problem.

U.S. CHAMBER'S ECONOMIST STANDS ALONE

Chairman **DOMENICI**. Let me just summarize so that we'll know, and so you all will know. I think you're the last set of witnesses that will be from the marketplace who will be talking to us. And I think to this point we had four representing realtors, manufacturers, small business, and one other. And I guess I asked very similar questions. I would like you to know that the U.S. Chamber's economist stands singularly on the side that he is taking here on the interest rates. I know you've been along many times on your economics; I don't say that for any reason but to tell you what we know, what they've told us.

Now, I'm going to yield to you, Senator Exon, for as long as you may desire.

Senator **Exon**. Thank you, Mr. Chairman, and welcome. I've been listening with keen interest, and I'm sorry I was late, gentlemen. I like to get over here and listen to the advice from people that I consider experts and all three of you are in that general area.

You have driven home once again what many of us in this committee have been saying all along, and that is that we've just got to attack the spending side of the budget. I think that, without belaboring the point, we have made some significant strides in the last 2 or 3 years in that general area, but we've got to do some more.

I was interested in what you had to say about an overall problem. Let me see if I can get at a question or two. We seem to be picking up some strong signals, that after the election the administration may well indeed come over with some enhanced revenue measures—that's the new term for tax increases. And that may very well be rather better than a 50-50 chance of being consumption tax, value added tax, call it what you will.

I'm not arguing the matter for the moment of whether or not we should have that. If the administration should come over here after the election in the lame duck session which I suspect we'll have, or otherwise, what would be your reaction to the positive or negative or worst of all worlds attitude toward a value added or consumption tax or a national sales tax.

Let's start with you, Mr. Kilpatrick.

TAX INCREASES OF SOME SORT NEEDED

Mr. **Kilpatrick**. Senator, we've not examined in depth a consumption tax or a value added tax. We will do so at the proper time, and we'd be glad to offer our views to you on those ideas as you deliberate them.

Let me return to the conceptual thought that we believe that we can't save our way out of this situation. We've got to have tax increases of one sort or another. I keep talking about the need for addressing spending first, but it's got to be a balanced package ultimately to get us out of this situation.

Senator **Exon**. Or it isn't going to pass. That's what you're going to say.

Dr. Rahn, I'm sure that you've given this matter some thought. I'd be very interested in hearing what you thought.

CONSUMPTION TAXES ARE LESS HARMFUL

Dr. **Rahn**. We now have a task force of the chamber's tax committee looking into some of these alternatives that are being discussed.

Clearly some forms of tax increases are worse than others. And at some time I expect we will have to come in here and rank them before you all.

Economists generally agree that consumption taxes are less harmful than are taxes on capital and labor. And to the extent that we ultimately change our tax system clearly I think this is the way we probably ought to go.

In terms of the question about the mix, I do not think we are so unrealistic to think that when you ultimately decide what should get passed, it will embody some tax increases. But I think we at the chamber consider our role as recommending to you what we think the best course of action is in terms of the economy.

Senator EXON. Thank you, Dr. Rahn. Mr. Sommers.

VALUE ADDED TAX HAS SIMPLICITY

Mr. SOMMERS. I strongly urge a value added tax, sir. A consumption tax opens up a variety of different ways of structuring the entire tax system, but it's a very long legislative course. You have to unlegislate a lot if you're goinq to legislate a consumption tax.

A value added tax has the virtue of simplicity. It doesn't conflict importantly with the existing tax structure. Its yield is rather formidable. I think a 1-point value-added tax now would yield about $14 billion. A 3-point tax would yield $42 billion, and it then would be necessary to rebate a portion of that on the personal income tax, in order to remove its more regressive impact.

A very good version of that law is available from 1972. Mr. Nixon's Treasury drew up a very satisfactory value added tax, and I suspect that if we had not had the ensuing complications, we might have gotten a value added tax then.

There are many other advantages I can list, but the basic advantage of a revenue raiser that is on the consumption side makes it quite desirable.

DOLLAR VALUE UNKNOWN

Senator EXON. Thank you. Dr. Rahn, I took it, and maybe I took it wrong from the answer to an earlier question that you gave that you didn't believe that the generally perceived, unrealistically high value of the dollar in the international marketplace today was a matter of serious concern, or did I misread your answer?

Mr. RAHN. I do not think we know what the value of the dollar ought to be. It's basically a market rate, and I agree we have had a lot of capital inflows for the reasons that Mr. Sommers laid out.

I do not think anybody really knows what that value ought to be. And given our history of intervention and the mistakes we have made, I am not sure what we do as corrective medicine may not be worse than the particular disease.

Given our current situation, like most things in economics, we have two-edged sword. If you are an exporter, particularly of price competitive products, you are very unhappy, as many of our members are, about the high value of the dollar.

If you are an importer of basic raw materials, or if you're a consumer, you are very happy about the high value of the dollar, particularly if you are an American tourist going to Germany, Japan, or France.

Senator **Exon**. If you have enough money to do that, Mr. Rahn.

Mr. **Rahn**. Yes. But everybody is a consumer in this country, and I would bet, in fact I would put a heavy bet on it that if the value of the dollar goes down sharply, we will see a big increase in inflation in this country, and I am not at all sure that's desirable.

PART OF DEFICIT BEING FINANCED BY FOREIGN DOLLARS

Senator **Exon**. Let's take the other side of that, Dr. Rahn. You know, I think I agree from an economic standpoint with everything that you have said. In fact, when Dr. Feldstein was here the other day, we got into a general discussion on this, and he said that while he thought the dollar was very seriously overvalued in the international marketplace today by 30 percent or more, he pointed out that as a result of this about 40 percent of our deficit today, according to his assumptions, was being financed by foreigners, by money coming into the United States.

And he pointed out that if we would have a sharp drop in that, it might be that the foreigners would pull their money out, it wouldn't be coming in, and we could have inflationary pressures, I assume that would be the result.

I wasn't thinking, maybe you thought I was thinking of, of a devaluation or something like that. I happen to feel that one of the reasons for the high value of the dollar today is the totally unwieldy budget deficits that we're having, plus that other thing that we dare not even talk about anymore, the totally skyrocketing national debt of this country that has doubled in the last 6 years, and certainly everybody agrees that it's going to go through the $2 trillion mark before the end of this decade, probably in the next few years.

But in any event, don't you believe that the high deficits and skyrocketing national debt is one of the major reasons for whatever overvalued dollar, whatever it has in the international marketplace, the high value of it? And wouldn't addressing the deficit and at least getting us on a down road to some kind of a match with income and outflow likely have a proper effect by reducing the value of the dollar that I think is highly overvalued at the present time?

Mr. **Rahn**. Clearly a good part of our deficit right now is being financed through foreign dollars. To the extent that the deficit does cause a higher real rate of interest, I agree that attracts the foreign dollar.

I seem to have trouble making myself clear. I notice both in the press and before congressional committees that many are strongly opposed to large deficits. However, because we are not in favor of big tax increases, that does not mean we favor large deficits. In my testimony, I went through a lot of the reasons why we want lower deficits.

Our concern is that many of the cures that are proposed are worse than the disease, and some of the medicine I see being proposed reminds me of the doctors who believed that they could cure

George Washington by bleeding him. I don't want that to happen to our country.

Senator **Exon**. Did I understand, Dr. Rahn, your testimony to indicate that you were questioning whether or not our interest rates in this country are really out of line with foreign countries?

Mr. **Rahn**. Well, if you look at OEC data, CBO data, OMB data, and if you take a look at it, real rates of interest, nominal rates, you cannot come to the conclusion that we are substantially out of line.

SAFETY BRINGS INFLUX OF FOREIGN DOLLARS

Senator **Exon**. If that is true, why is it that we have such an influx of foreign dollars to where according to Dr. Feldstein they're coming in here at the rate, or they finance about 40 percent of our deficit today. Is it just safety?

Mr. **Rahn**. It is safety. It is due to the fact that we have lower rates of inflation and the United States is the best investment opportunity of any country in the world right now. Our recovery began before other nations. We have higher rates of real economic growth. If you are a foreign citizen you want to invest in those places of the world where you can make the maximum amount of money.

Right now the United States is doing much better. The Europeans' economies have stagnated. You do not have investment opportunities there. I think that what we are seeing is an illustration of classical market behavior, constructive behavior of the world currency, and I agree with Mr. Sommers that we really do have a world currency now, and that is flowing to the United States because we have a hearty business environment.

Senator **Exon**. Mr. Sommers, what do you think of that?

Mr. **Sommers**. I don't agree. The U.S. interest rates are high by the appraisal of every banker in Europe. A large part of the investments coming over here are not of a productive, in-the-ground type. Some are; a great deal are not. They are simply portfolio investments invested here for yield. And the reason is that our nominal and our real interest rates are higher than in any developed country in the world.

What these figures indicate I would have to study, but I got back from Europe a week ago, and let me assure you, the dollar market in Europe is incredible. The volume of speculative investment in dollar denominated securities, not in plant and equipment, is enormous. The 40 percent that Mr. Feldstein referred to—Mr. Feldstein said 40 percent of our budget deficit—Mr. Volcker estimated $80 billion for 1984—that inflow is not going into productive equipment at all; it is going into financial instruments. And it's doing it because the yield here is simply the best available yield.

May I comment a little further on the business of the dollar and my suggestion that coordination in handling it with other central banks is necessary? I am not suggesting massive intervention in the dollar to move it far from where the market would put it. I'm saying that the dollar is substantially overvalued; that if we behave ourselves over the next couple of years, it will come down in value.

Senator **Exon**. What do you mean by behaving ourselves? You mean economically?

Mr. **Sommers**. Reducing our deficits, and seeking a lower level of interest rates for real growth and real saving in the United States. Under those conditions, we will be a less attractive market, and the foreign dollars which neither we nor Mr. Volcker controls will at the least stop flowing in, very conceivably flow out.

All I'm asking for is a stable decline that minimizes the kind of speculative violence that occurs in speculative markets. And the dollar is now a speculative market.

Senator **Exon**. Dr. Rahn, you obviously would like to say something.

FOREIGN INVESTMENT DISPLACES U.S. INVESTMENT

Mr. **Rahn**. I disagree with his whole notion that because foreigners buy U.S. securities that is not money going into plant and equipment. Money is fungible. If we look at the new securities market in this country, it has been doing very well. These funds go to buy plant and equipment. Foreigners help by buying secondary securities, because that frees up the money of others to go into primary securities.

A notion that because you buy existing GE stock or an existing bond, that it doesn't help us with plant and equipment, I think, is ridiculous.

Mr. **Sommers**. The portion going into that is not really very large. The fact is the bulk of the real investment in the United States is being done by U.S. investors. It's true that foreign investment displaces U.S. investment, and in that sense it's beneficial generally to us. But European investment is predominantly in dollar-denominated, short-term financial assets seeking yield.

Senator **Exon**. They're buying T-bills.

Mr. **Sommers**. T-bills. That's the budget deficit.

Mr. **Rahn**. Well, to the extent they buy T-bills, then Americans do not have to buy as much—I don't know how you differentiate who is buying what there, we don't keep statistics on that—but that money is freed up to go into productive plants and equipment, and we see it all around this country.

In fact, during this recovery, despite what is put in the Washington Post and much of the other media, plant, and equipment spending has come back far faster than in other recent recoveries, and we can provide you with the detailed data on that.

I am quite optimistic and very satisfied with the way that aspect of our economy is going.

Senator Exon. Thank you, Dr. Rahn. Could I have your view of this, Mr. Kilpatrick?

Mr. **Kilpatrick**. Senator, I'm not an economist. I'm just a businessman trying to run a business. I do know, though, that I run a company that invests several billions each year, and I've never known interest rates, real interest rates to be as high as they are now.

I also know that as a company that does a lot of business overseas, I agree with the proposition that I heard Lee Morgan, who heads Caterpillar, testify to not long ago, that there's a considerable tax being exacted on American business trying to do business overseas. The dollar is too high. It's overvalued, and in our view that overvaluing traces itself right back to the deficit and real interest rates.

OVERVALUATION OF DOLLAR IS KILLING AGRICULTURE

Senator EXON. I would just tell you gentlemen that I think all too often we intend to look at things through the eyes of manufacturing and business, which is good. But I will simply tell you as a Senator from a key agricultural State, the overvaluation of the dollar is actually killing us in agriculture today.

Most people agree that it certainly is impossible for us to sell our agricultural products overseas today. We're selling wheat today cheaper than our main competitors, Australia and Canada, and yet we're getting killed because of the high value of the dollar.

I would simply tell you that in agriculture today the ballooning trade deficit, of which agriculture is a large part of the shortfall, is very serious.

One last question and then we'll finish, up, gentlemen. And you can each comment on it if you will. I guess when you look to the future, we can all recognize that we've got to reduce some spending, and we've got to get to someplace where we balance income with outflow.

As 8 years Governor of a State, we balanced each and every year. No. 1, we wanted to. No. 2, we had to under the constitution, the latter being the driving force, I presume, but at least it was done.

I happen to be for a constitutional amendment for a balanced budget. I wasn't sure that was necessary when I came here, but I'm convinced the discipline is not here for a variety of reasons.

I would simply say that I think there is nothing better to control spending, and therefore taxes, than to have the people who authorize the expenditure of the money, including the President of the United States, be the ones that also have to recommend the taxes to pay for that spending in each and every year.

You know, that has a phenomenal effect upon how people put out money. As we look to the future—just one last question, and don't take a lot of time, but comment on it if you will—I keep wondering what has been the main reason for the up turn in the economy during the last year and a half, and how we're going to keep that going in the future.

And I'm concerned with the fact that maybe too much of this is due to stimulant. We generally have the good times rolling when we have huge deficits, meaning we're spending more money in the Government than we're taking in.

That generally stimulates the economy and gets things going. We have two additional factors right now, the massive tax cut. That alone generally causes things to take off and do well. And thirdly we generally do well in the economy in America when we're on a wartime footing.

Now, I think few people can argue today that our defense budget, and most of it I think is necessary, is a wartime footing.

I guess what I'm saying is with those three massive stimulants into the economy, is it any wonder that the good times are rolling today, whether or not we can argue it's rolling equally in different parts of the country? Mr. Kilpatrick, what do you think?

TAX CUTS HAVE HAD MOST TO DO WITH CURRENT RECOVERY

Mr. **Kilpatrick.** I think all of those factors have contributed to the current recovery. If I had to pick out one, I think the tax cuts have had more to do with the current recovery than anything else.

We would have to give some credit to the Federal Reserve as well. They've been very steadfast in the fight against inflation. And we shouldn't lose sight of the fact that just 2 or 3 years ago we were all sitting around here and that was our big worry, inflation.

So I think Paul Volcker deserves a lot of credit on that.

As I look at the future, however, it's a rolling proposition of what do we deal with here. And while I did say earlier that we can't save ourselves out of this dilemma, I can also say with equal conviction we can't tax our way out of it. A big tax increase in my view would be disastrous. But I think we need some balancing of taxing and spending cuts particularly with putting some restraints on the entitlement programs, and especially non-means tested entitlements.

Senator **Exon.** Dr. Rahn.

RECOVERY GENERATED BY TWO THINGS

Mr. **Rahn.** Well, the recovery was generated by two things. The reduction in marginal tax rates—and I would take issue with your term of a massive tax cut. In 1976, Federal taxes took 18.3 percent of GNP. This past year they took 18.6 percent. During the late seventies and the beginning of the eighties, the percentage was a little bit higher than that. But in terms of percentage of GNP, the tax take really has not changed much.

We did improve the structure, or you gentlemen improved the structure of the tax system, and you ought to be proud of that.

The second thing that brought about the recovery was the change in Fed policy to a more expansionary money supply growth in late 1982 and early 1983. Now, of course the previous Fed policy, which we had disagreed with and which was below our targets of very tight monetary growth during early 1982 brought on a deeper recession, and delayed the recovery.

Also, the deregulation which began during the Carter years, has been taken further in the last year or two, and that clearly has benefited all Americans.

Senator **Exon.** Thank you. Mr. Sommers.

Mr. **Sommers.** The reasoning about what causes changes in the economy regresses infinitely. It's very hard to find out where you ought to start.

Starting just in the fall of 1982, I would say this recovery was born in an immense shock of policy stimulus, which combined an active government deficit—imposed on us by tax reduction—not just the passive deficit that's measuring where we are with respest to high employment, but a deliberate imposition of an active budget deficit combined with extraordinarily accommodative monetary policy.

Deficits are not stimulative unless they are validated by the Federal Reserve. In the last half of 1982, in my judgment very properly, the Federal Reserve validated, under desperate conditions.

But that was a Mount St. Helens, the budget deficit and the money growth together. What is happening now is that the Federal Reserve, and again I would not say improperly, feels no longer willing or able to continue the funding of the deficit at a time when the prospect for the deficit goes on indefinitely into the future. So things are changing now for that reason.

Senator **Exon**. Mr. Sommers, that's my point, and you've come back to it. If we try to talk about the future, I guess we have to try and get a handle on what happened.

It's quite obvious to me that we are not going to have a further reduction in marginal rates. We're not going to have a massive tax cut. We're not going to have a reduction in revenue, whatever you want to call it.

And evidently we are not going to have accommodation of the Federal Reserve for the reasons that they're doing everything that they can to make sure that, at least at this juncture, we do not go back to what governments have always done, and that is to pay off our national debt or deficit with inflation.

I'm simply saying that it appears to me that the collision of all these policies could give us some difficulties in the immediate future.

Gentlemen, thank you very much. It's been an interesting discussion for me, and I appreciate it. Thank you, Mr. Chairman.

MASSIVE INJECTION ON EXPENDITURE SIDE NOT INTENDED

Chairman **Domenici**. I do want to say with reference to your last comments about massive injection on the expenditure side, we clearly didn't intend that. I guess you know that. We had deficits much, much smaller in mind. But we didn't get the recovery and the things that were contemplated, so we got recession-imposed deficits that I guess you would nonetheless call an injection using the notion of spending more than you take in.

But it came pretty close on the expenditure side to what we planned up here, and if you look at the deficits expected, they were much less.

But you expected recovery quicker. Less unemployment, more inflation, et cetera. But nonetheless the effect may be there. It certainly wasn't contemplated.

Thank you, gentlemen. We stand in recess.

[Whereupon, at 3:02 p.m. the committee was adjourned.]

VIEWS OF THE FEDERAL RESERVE SYSTEM

WEDNESDAY, FEBRUARY 29, 1984

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 9:40 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Boschwitz, Quayle, Chiles, Biden, Johnston, Sasser, Riegle, and Exon.

Staff present: Stephen Bell, staff director; and Gail Fosler, chief economist.

For the minority: Richard N. Brandon, staff director; and Garry Schinasi, senior economist for macroeconomics and fiscal policy.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman DOMENICI. It is a pleasure to welcome you this morning, Chairman Volcker. As you know, extensive discussions are underway between Members of Congress and the administration to determine if we can reach an early and substantive agreement on budget policy.

If we are going to make any significant progress on a budget this year, it seems to me that these discussions have to succeed. We are fortunate to have a little time. Economic growth is strong and unemployment is coming down. However, the financial markets, which are typically forward-looking, are unsettled, and that, in turn, is unsettling many of us.

The Dow lost another 23 points yesterday and is down about 8 percent since January. I personally am very optimistic that we can reach some kind of interim agreement on the budget, but the longer term problem is an enormous one. It cannot be resolved in a single year, but we certainly have to start the process.

DEFICIT REDUCTIONS HAVE TO BE ENACTED

Current policy baseline projections show the deficits rising from $190 billion to over $300 billion by 1989. We have to enact deficit reductions this year. I am hopeful that we can put together a package of somewhere between $100 and $150 billion in deficit reductions; maybe $160.

I hope we can do that with some significant outlay savings and not all revenue increases. I think we can reduce spending in defense and the other parts of the budget; maybe all three, defense, nondefense, and taxes, could bear some reasonable share of this deficit reduction.

Given the size of the problem, even in this body some are calling for broad, sweeping solutions. This is clearly a case where, in my opinion, we are going to have to do something significant. Hopefully, we can do it in a bipartisan manner but whether we can achieve a whole cure in an election year seems to me to be problematic.

If we are going to freeze the entire spending and tax side of the budget for one year—that is, freeze it all—we would reduce budget deficits by $185 billion over 3 years. I merely offer that as an example of the kind of difficulty deficit reduction prescribes for us this year.

Even after actions like freezing defense budget authority for 1 year and then let it rise at 5 percent real growth, allowing no COLA's on Federal pay, we would require some form of across-the-board tax increase or further spending reductions if we were going to achieve $200 billion in deficit reduction.

So I give you these because I want you to understand the difficulty we have, and you have to be our partner, as I see it, in terms of us doing our share and you doing your share to see that this economy remains vibrant.

The administration is not going to propose these budget actions. The Congress is not going to enact them.

RANGE OF AGREEMENT

The fact is that there is a range of agreement. There is a set of policies that I believe could have the majority support of both Houses. But these policies fall far short of a total solution.

I will say to you, Mr. Chairman, we also need to see the effects of our policy changes in the overall budget numbers. You are well aware of the devastating effect of higher interest rates on Federal interest costs. The process of substantial and permanent reductions in the Federal deficits will take several years. If interest rates rise by very much, all of our changes in budget policies will be wiped out as a result of higher interest costs. Support for deficit reductions cannot be sustained unless it appears that we are, indeed, making some progress in bringing the numbers down.

I am pleased that you are here and I think we have a couple of hours, so we ought to get in all the questions that Senators have in mind. They have a tendency, many of them, to think that Congress ought to run the monetary policy of the country. I hope they all come today and ask you whatever they have in mind. I am sure you are prepared for that.

Senator Chiles, I yield to you at this point.

Senator **Chiles**. Thank you, Mr. Chairman. I am interested in the latest proposals you are putting on the table to freeze defense, raise taxes across the board, and freeze COLA's. That shows a real flexibility on your part. We might be able to move something on that.

Chairman **Domenici**. Do you think so? Do you think you could vote for that?

Senator **Chiles**. I think you have got some real interesting thoughts there. I am glad to see those on the table.

Chairman **Domenici**. I was thinking you were proposing them. [Laughter.]

Senator **Biden**. Maybe if we all got in a room and did it together, we would all come out proposing.

OPENING STATEMENT OF SENATOR CHILES

Senator **Chiles**. Mr. Volcker, we are delighted to have you with us this morning. In fact, a lot of people in this Committee envy you; my friend to the right, Joe Biden, does. Your election year was 1983 and you do not have to worry about politics at all anymore, so I know you can be very candid with us today.

You have been very successful in your fight against inflation. In fact, after 3 years of the current administration's economic program, your actions account for the lion's share of the success we have had in stopping inflation.

We still have a long way to go if we are ever going to get out of our economic dilemma. We see what the deficit is doing to us. We have had a recovery, but it has been lopsided, fashioned almost exclusively out of increased consumer spending. An overweight dollar has distorted our trade balance so that we are running record deficits there as well as with the prospect of the trade deficit even going higher.

With deficits keeping interest rates high and heavy Federal borrowing putting pressure on lenders, certainly we run the risk of crowding out new investment. This, of course, is a threat not only to our future growth, but also a threat to the very type of cure all prescribed by the administration for most of our economic problems.

RESOLUTION ADDRESSES DEFICIT PROBLEM

That is the main reason that we have introduced into the Senate a Senate concurrent resolution which addresses the deficit problem. The heart of that measure is a call for the President to revise and resubmit his 1985 budget and cut the deficit by $200 billion over the next 3 years.

It seems to me that this resolution frames our current problem. It addresses both the size of the deficit and the need to cut it now. You will recall that you joined with Senator Domenici and myself in a conference on the deficit in Miami earlier this year. At that time, you said that we had to cut the deficit by at least $50 billion a year for the next 3 years.

Certainly, that was good advice, and the Congressional Budget Office reestimates of the President's budget reinforce your opinion. If we make no changes in the President's proposal, the deficit will grow to $233 billion by 1987, and pass the $300 billion mark by 1989.

If we make changes to reduce the deficit by $100 billion over 3 years, the deficit will still be $195 billion by 1987. I would like your assessment of what that would mean to interest rates if the deficit were still that high 3 years from now.

So that is why I have proposed cutting the deficit by $200 billion by 1987. The deficit would still be $146 billion that year, but it would be on a steady, downward path.

The key is to start now. If, as the President prefers and as Budget Director Stockman made clear to the Governors Association this week, we do nothing in this election year, then we really cannot have an impact until 1986. That would mean at least 2 more years of growing problems, growing deficits, bigger interest payments on the national debt, and continued high, real interest rates.

Chairman Volcker, with the well-earned praise that you have received for your inflation fight, there is some public speculation that the White House may be setting you up to take the blame if the economy fades before the election. Some Federal Reserve officials have denied there is any pressure on you, but I think we would like to have you address that issue yourself today.

Certainly, I think we had better get to work cutting deficits substantially this year. I hope you will give us your thoughts on that matter during the course of this hearing.

Chairman DOMENICI. Mr. Chairman, you may proceed. We are glad to have you.

STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Mr. Chairman, Senator Chiles, let me say first of all that I think I have some understanding of the difficulties that you gentlemen face on this committee. It is relatively easy for me and for others to tell you in a hypothetical way what it is nice to do. It is quite another thing to actually plan and enact the difficult measures, whether on the spending side or the tax side, that are required to bring the deficit down.

I find your optimism encouraging, Mr. Chairman. There certainly is a need for early action and I would reiterate what Senator Chiles just said; the earlier it comes, tbe better, because we now have a strong economy and budgetary restraint would certainly fit into that picture in terms of keeping the economy balanced as well as strong.

There is also the almost arithmetic fact that the longer you wait, the more the problem compounds because of the interest you have to pay on the deficits that ensue.

I have a statement that starts out with the general economic background; I will just summarize that part of it. I do think there are many reasons to take an optimistic view of the future.

OPPORTUNITY FOR LONG-LASTING EXPANSION

We have an opportunity here for a long-lasting expansion. One of the reasons I feel optimistic is because of the progress that has been made against inflation, and that is absolutely fundamental to bringing interest rates down further over time and keeping them at lower levels.

In some respects, the expansion has not been as well balanced as we would like to see it, and that creates problems and challenges of its own. The inflationary situation itself, I think, is a matter that requires continuing attention; it always will, I suppose. The progress that has been made is dramatic on the one hand, but I do not think it has been going on long enough.

It is not built in enough yet in terms of expectations and behavior to afford any grounds for relaxation. Of course, that is a concern of Federal Reserve policy, in particular. The areas of imbalance have been referred to already. We have a growing foreign trade deficit; that is, the international sector of the economy, whether they are exporters or people competing with importers, have not shared in recovery.

There has been an increase in some types of investment at a good rate of speed, but that is mostly short-lived investment, particularly electronic equipment which goes up rapidly and is written off fairly rapidly.

In terms of major investment of the expansion variety, it has remained very sluggish, and that is the kind of investment that is more effected by historically high levels of interest rates. And that becomes an increasing problem as the recovery and expansion continue because we are reaching the stage where we will soon have to worry about capacity bottlenecks in particular areas of the economy.

It is a mixture of good news of very great, longer term opportunities, but a number of problems. And the best thing you can say about those problems is, I think, that most of them are susceptible to policy action, and that is what we are talking about this morning.

MONETARY POLICY

In terms of monetary policy, just to briefly review where we stand at the moment, we announced some weeks ago ranges for the various monetary and credit aggregates for 1984. They are essentially the same as those we tentatively set forward in July 1984.

In setting forth those ranges we envisaged that relationships between monetary and economic activity and inflation, summarized in the velocity of money, will broadly follow more normal trends and cyclical developments after departing markedly from past patterns in 1982 and early 1983.

On that assumption, we do believe that the targets we have set out should be fully consistent with real economic growth in 1984 in a range of 4 to 4¾ percent, provided that inflation, as we anticipate, does not accelerate markedly. That would be consistent with further expansion in employment and a further reduction in the unemployment rate. Members of the Open Market Committee projected an expectation of a decline in the unemployment rate to the 7½-percent range or little higher by year's end.

Those projections, I think, are broadly consistent with those presented by the administration, by the Congressional Budget Office and by many outside forecasters for 1984.

As the year progresses, we will certainly want to assess closely the relationships between monetary growth and economic activity and inflation. We will test the assumptions that we have made that velocity relationships are returning to normal. But in doing that, we are conscious of the need to avoid any strong resurgence of inflationary pressures as the economy expands.

PROJECTIONS BEYOND 1984 MORE PROBLEMATICAL

When one looks at projections extending beyond 1984, they are necessarily more problematical. The administration and the Congressional Budget Office, as you know, project a continuing economic growth, continuing reductions in unemployment and, in varying degrees, further progress against inflation.

That kind of projection seems to me to be reasonable as a basis for planning, but I do not want to suggest that those kinds of assumptions are realities. What we are talking about here are policies that will make those kinds of assumptions reasonable estimates of the future, but it does depend upon policy actions.

Let me say that a more rapid monetary and credit growth in an effort to speed progress toward lower interest rates seems to me all too likely to be counterproductive. The economy, driven in large part by the purchasing power implicit in the deficit, is already growing at a satisfactory pace.

By feeding the concerns about inflation, excessive monetary growth would, in the end, have a perverse influence on interest rates. The resultant heightened fears of inflation and instability would only reduce incentives to save and the willingness of firms to make long-term commitments to productive investment.

The continuing flow of funds from abroad upon which we are dependent for the time being would be discouraged. Depreciation of the dollar externally as a result of inflationary policies would not, in the end, help our exporters or those competing with imports because that depreciation would be accompanied by inflated domestic costs.

In a real sense, the one key contribution that the Federal Reserve itself must make to our lasting prosperity is to foster the expectation, and the reality, that we can sustain the hard-won gains against inflation because in the end, that will set the stage for further, lasting reductions in interest rates and a better balanced expansion in economic activity generally.

ROLE FOR FISCAL POLICY

What we cannot do by manipulating the money supply is to achieve a better balance between the demand for and the supply of savings. That is, as I see it, the essential role for fiscal policy.

The state of the Federal budget affects both directly and indirectly the demands on the economy. The increase in the deficit that was recorded last year on the one hand helped to account for the speed of the rebound in economic activity, even though interest rates in historical terms remained high.

The deficit, in effect, increased purchasing power at a time when the economy was still feeling the effects of recession. However, as the economy has grown, the adverse effects of the imbalance of domestic savings and investment on credit markets and on our external accounts have become more apparent.

And those imbalances can only worsen if deficits of the magnitude projected by the CBO and others—deficits without precedent during a period of economic expansion—are permitted to materialize in coming years.

I have attached two charts to my statement to help illustrate the sharp difference between the present budgetary trajectory and previous periods of economic recovery and expansion.

SOURCES AND USES OF AVAILABLE SAVINGS

The first of those charts,[1] summarizing sources and uses of available savings, shows graphically how the deficit in 1984 will continue to account for more than half of the demands for savings, net of depreciation.

Those demands will, in fact, substantially exceed our capacity to save domestically—an amount that for many years has fluctuated roughly between 6½ and 8½ percent of the GNP. Consequently, we are forced to increasingly look abroad for capital to supplement our domestic savings.

For some time, we have been able to draw upon foreign savings relatively easily. Funds have been attracted not just by our interest rates and by our strong stock market, but by relative confidence in our economic and political stability. The effect has been to blunt some of the impact of the budget deficit on our interest rates and to help finance both the deficit and investment generally.

But over time reliance on increasing amounts of foreign capital is a tenuous and risky way to finance domestic growth and capital formation. It exacts a large cost in terms of rising trade and current account deficits—deficits that cannot be sustained indefinitely.

Moreover, a steady and growing flow of foreign capital is dependent on confidence in our ability to manage our economic affairs, on relatively high interest rates, or on both.

To the extent our monetary or fiscal policies fail to justify that confidence, to the extent inflationary pressures again appear to be ascending or our external financial position is steadily weakened by large foreign borrowings, the greater the risk that new capital flows from abroad will come less freely, with adverse consequences for the dollar and for interest rates.

SHARE OF TOTAL CREDIT TAKEN BY U.S. GOVERNMENT

The second chart[2] underscores the extraordinary nature of our present fiscal position. In only one earlier recession period, 1975, did the Federal Government absorb so large a share of total credit flows, and in every postwar economic cycle borrowing by the Treasury diminished substantially as a share of total credit flows during the second year of recovery.

In contrast, the fraction of credit going to the Treasury, at 35 to 40 percent, will not decline much, if at all, this year from the unusually high level we saw in 1983.

To put the point another way, Treasury debt is expected to increase about 17 to 18 percent this year. Assuming total credit grows about 10 percent this year, just above the midpoint of the Open Market Committee's range, all other demands for credit could rise by some 8 percent, no more than in 1983, the first year of recovery. That would be an unusual cyclical pattern.

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[1] See p. 546.

[2] See p. 547.

The Treasury is going to get the funds it needs to cover the Federal deficit. The question is whether other sectors will get enough funds at reasonable interest rates to support the balanced, higher investment expansion we want.

To some extent, improved profits and cash flow relative to other recent expansions could help to forestall excessive pressures. But the kind of expansion we and others foresee does imply more business borrowing and housing and consumer credit needs, increasing by 11 and 15 percent respectively over the last half of the past year, are already expanding rapidly.

In essence, the demands of the Federal Government limit the rate of growth of other credit-absorbing sectors of the economy. The rationing device is interest rates held higher than would otherwise be the case. Under the circumstances, the more rapidly the economy grows and generates private credit demands, the greater the risk of rising interest rates.

CONTINUED ECONOMIC EXPANSION DESPITE FINANCIAL STRAINS VISUALIZED

We can, in concept, visualize an economic expansion that continues despite financial strains—an expansion characterized by relatively high interest rates and by high consumption supported by large deficits, but also by markedly sluggish investment and a widening trade deficit.

That in itself is hardly desirable in terms of the staying power of the expansion and future growth in productivity. But we also have to be conscious of the added risks such financial pressures would pose to thrift and other financial institutions, to less developed countries with heavy debt burdens and their creditors in the United States and elsewhere, and to the fabric of international trade. At some unknown point the sustainability of the expansion itself would be jeopardized.

We cannot reasonably escape from these problems by monetizing the Treasury debt through excessive expansion of bank credit. The Federal Reserve could, in concept, take an approach which inflated all the numbers, but it cannot increase savings and reduce the savings-investment imbalance by undermining confidence.

What must be done is to deal with the source of the problem, the excessive deficits. While it is already late to make any significant changes for fiscal year 1984, action now affecting fiscal 1985 and later years can only work in the direction of moderating potential pressures. If sufficiently forceful, the market could then well anticipate the time the actions become effective. At the least, the risks of eroding confidence and new market pressures should be relieved.

EXPEDITIOUS ACTION TO REDUCE DEFICITS DESIRABLE

I know you are aware of another reason why expeditious action to reduce deficits is desirable: the large deficits now being projected can be self-perpetuating.

The direct effects are obvious. Interest payments on debt issued to finance this year's deficit add to the deficit next year, and interest payments on those deficits increase exponentially into the future, making it more difficult to reverse the momentum.

Let me illustrate the point somewhat differently. The administration and the CBO's estimates of the administration's budget program differ in considerable part because of the underlying economic assumptions used.

Specifically, the higher deficit forecasts of the CBO assume that interest rates will not decline as much as the administration assumes, compounding the effects of higher deficits originating from other factors. But if we seize the opportunity to take stronger and early, positive action to reduce the deficit, and that action helps encourage lower interest rates than projected by the CBO, then the deficit can be placed on a trend more in accord with administration estimates.

In other words, procrastination plainly exacerbates the problem, leaving us all with still more difficult choices not very far down the road.

NEXT BUDGETARY PRESSURES

Somewhat less obvious may be the next budgetary pressures arising out of the attempts of various interests—consumers, workers or firms—to offset the effects of sustained high deficits on our international competitive position and on interest rates.

For example, the deterioration in the position of our industrial and farm products in world markets is already generating demands for subsidies, tax relief, and special protections for economic sectors as diverse as the family farm and the steel industry. The effects of high-interest rates in construction and housing costs call forth requests for new programs in those areas.

I know all of this is, by now, very familiar to you. The real obstacle to action seems to me not intellectual, but the difficulty of reaching a practical, workable consensus on specific spending or revenue measures to deal with the problem.

In a sense, it seems to me, dealing with the deficit has been everyone's second priority; the first is particular spending programs or measures of tax relief that, viewed in isolation, have justifications of their own.

Decisions in those areas, with political as well as economic dimensions, are not within the competence of the Federal Reserve and I can only urge that they be faced sooner rather than later before we are enveloped with an atmosphere of crisis in financial markets and elsewhere.

Much has been achieved in these last few years to put the economy on a sounder footing—too much at too great a cost to see it all jeopardized now. The risks arise mainly from our own actions or inaction. The amounts required to make a real difference to bring the trend of deficits under control are surely not beyond reach. It has been done in the past and I am convinced it can be done again.

Thank you, Mr. Chairman.

Chairman Domenici. Thank you very much.

[The prepared statement of Mr. Volcker follows:]

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on the Budget

United States Senate

February 29, 1984

Mr. Chairman, and members of the Committee, I am pleased to appear before you today as you focus on the first Concurrent Budget Resolution for fiscal year 1985. I shall address myself briefly to the prospects and challenges that face us as we consider both monetary and fiscal policies for the remainder of 1984 and the years beyond. I believe we have much upon which to build in working toward long-lasting expansion. But it also seems to me evident that difficult decisions are necessary now to make that prospect a reality.

Over the past two years inflation has slowed dramatically, reaching the lowest rate in about a decade. The first of those years was a period of serious recession. But 1983 was a year of recovery stronger than most had believed was likely to occur. The increase of almost 6-1/4 percent in real output during 1983 was roughly in line with the postwar recovery norm, and the decline in unemployment has been even sharper than usual. The fact that we were able to achieve vigorous recovery while containing inflation is what is so promising for the future.

The pressures of recession, deregulation of some important industries, and import competition have all contributed to a greater sense of discipline and realism in pricing and wage bargaining. But we cannot, of course, claim success against inflation until we can combine greater price stability with prosperity over an extended period.

The chances of "building-in" greater stability will depend heavily on workers having the opportunity for gains in real earnings and on satisfactory corporate profits. The past two years have provided a more favorable setting in both respects. The real income of the average worker has risen as price increases slowed faster than wages. After-tax economic profits have recovered strongly and, relative to the GNP, are close to the highest years of the 1970's.

If these gains are to be maintained, we shall need productivity growth, we shall need a balanced expansion that avoids bottlenecks, and we shall need to encourage competition and investment.

There is some evidence that the dismal productivity trend of the late 1970's is changing for the better. Some of that evidence is qualitative or particular to one industry or another -- new efforts at cooperation between management and labor, more flexible work rules, and less regulation. On an aggregative level, the evidence, while not yet conclusive, suggests that we may be seeing not just typical cyclical gains in productivity but also more lasting improvement. Productivity gains from here on are likely to be smaller than those seen in the initial quarters of recovery. But there is also reason to hope that the skills of a more experienced work force, coupled with management innovations and technological progress, can sustain a somewhat more favorable trend over the years ahead.

That prospect is, of course, dependent in important part on new investment -- as is our ability to avoid bottlenecks. We have, indeed, seen a rapid increase in some types of investment during the recovery period. But so far, rising business investment has been largely concentrated in relatively short-lived equipment rather than in long-lived plant or major machinery that would add substantially to production capacity. Housing has also rebounded. But, overall, net new private investment has remained relatively low as a proportion of total GNP, as shown in Chart I attached.

As we move from recovery to the expansion phase of economic activity, business investment should rise over a broader front. Changes in tax laws enacted in recent years should work in that direction. But the question remains whether we can, as a nation, generate the supply of savings necessary to support both rising investment _and_ a huge government deficit. That, it seems to me, is the key policy issue before us.

The importance of dealing with that issue is highlighted by several well-known facts. Interest rates are already high -- too high -- in absolute terms and relative to current price trends, tending to restrain those types of investment where interest costs loom large. In at least a few industries -- paper, certain plastic materials, some types of electronic equipment -- capacity constraints are already looming, and long lead times for investment mean that plans must be implemented soon to avoid bottlenecks and threats to noninflationary expansion. As the economy grows, more inventory investment will also be needed, adding another demand to our limited supply of savings.

For the time being, we have been able to supplement our domestic savings by drawing on a large capital inflow from abroad. But, as I will discuss a little later, that development carries risks and dangers of its own and cannot be sustained indefinitely.

Monetary Policy

I have recently reviewed in some detail with the Banking Committees our intentions with respect to monetary policy. In summary, the Federal Open Market Committee essentially reaffirmed the ranges for the monetary and credit aggregates for 1984 that were tentatively established last July. Those ranges call for growth of the broader aggregates, M2 and M3, between 6 and 9 percent and growth in M1 of 4 to 8 percent. These ranges, shown on Table 1, which is attached to my statement, are 1/2 to 1 percentage point below those for 1983.

The ranges for 1984 envisage that relationships between monetary and economic activity and inflation -- summarized in the "velocity" of money -- will broadly follow more normal trends and cyclical developments, after departing markedly from past patterns in 1982 and early 1983. On that assumption, monetary and credit growth should be fully consistent with real economic growth in 1984 in a range of 4 to 4-3/4 percent, provided that inflation, as anticipated, does not accelerate markedly. The gains in output are expected to generate a further expansion of new job opportunities and the unemployment rate is expected to decline to the area of 7-1/2 to 7-3/4 percent by year's end. These economic projections, which are "central" tendencies of projections of the members of the FOMC, are broadly consistent with the short-term projections of the Administration and the Congressional Budget Office.

We do intend, as the year progresses, to assess closely the relationship between monetary and economic activity and inflation, testing the assumptions and the analysis that suggest more normal "velocity" relationships are returning. In shaping policy, however, we are strongly conscious of the need to avoid any strong resurgence of inflationary pressures as the economy expands.

Economic projections extending several years ahead are necessarily more problematical. Both the Administration and the Congressional Budget Office have projected continuing growth, reduced unemployment, and, in varying degrees, limited further progress against inflation. Projections of that sort, as a basis for planning, seem to me reasonable. But we should not be deluded into mistaking a projection for a certainty -- or even a probability -- unless we are willing to take the measures reasonably necessary to achieve that end. Specifically, the way the final choices before this Committee are reached will bear critically on the chances of meeting those economic projections.

In this context, more rapid monetary and credit growth in an effort to speed progress toward lower interest rates would all too likely be counter-productive. The economy, driven in large part by the purchasing power implicit in the deficit, is already growing at a satisfactory pace. By feeding the concerns about inflation, excessive monetary growth would, in the end, have a perverse influence on interest rates. The resultant heightened fears of inflation and instability would only reduce incentives to save and the willingness of firms to make long-term commitments to productive investment. The continuing flow of funds from abroad, upon which we are dependent for the time being, would be discouraged. Depreciation of the dollar externally as a result of inflationary policies would not, in the end, help our exporters, or those competing with imports, because that depreciation would be accompanied by inflated domestic costs.

In a real sense, one key contribution that the Federal Reserve itself must make to our lasting prosperity is to foster the expectation -- and the reality -- that we can sustain the hard-won gains against inflation. In the end, that will set the stage for further lasting reductions in interest rates and a sustained, better balanced, expansion in economic activity generally.

The Role for Fiscal Policy

What we in the Federal Reserve cannot do, by manipulating the money supply, is to achieve a better balance between the demand for, and supply of, savings. That is the essential role for fiscal policy.

The state of the federal budget affects both directly and indirectly the demands on the economy. The increase in the deficit that was recorded last year helped account for the speed of the rebound in economic activity, even though interest rates, in historical terms, remained high. The deficit, in effect, increased purchasing power at a time when the economy was still feeling the effects of recession. However, as the economy has grown, the adverse effects of the imbalance of domestic savings and investment on credit markets and on our external accounts have become more apparent. And those imbalances can only worsen if deficits of the magnitude projected by the Congressional Budget Office and others -- deficits without precedent during a period of economic expansion -- are permitted to materialize in coming years.

The two charts I have attached to my statement illustrate the sharp difference between the present budget trajectory and previous periods of economic recovery and expansion. The first of those charts, summarizing sources and uses of available savings, shows graphically how the deficit in 1984 will continue to account for more than half of the demands for savings (net of depreciation). Those demands will, in fact, substantially exceed our capacity to save domestically -- an amount that for many years has fluctuated roughly between 6-1/2 and 8-1/2 percent of the GNP. Consequently, we are forced to increasingly look abroad for capital to supplement our domestic savings.

For some time, we have been able to draw upon foreign savings relatively easily. Funds have been attracted not just by our interest rates and by our strong stock market, but by relative confidence in our economic and political stability. The effect has been to blunt some of the impact of the budget deficit on our interest rates, and to help finance both the deficit and investment.

But, over time, reliance on increasing amounts of foreign capital is a tenuous and risky way to finance domestic growth and capital formation. It exacts a large cost in terms of rising trade and current account deficits -- deficits that cannot be sustained indefinitely. Moreover, a steady and growing flow of foreign capital is dependent on confidence in our ability to properly manage our economic affairs, on relatively high interest rates, or both. To the extent our monetary or fiscal policies fail to justify that confidence -- to the extent inflationary pressures again appear to be ascendant or our external financial position is steadily weakened by large foreign borrowings -- the greater the risk that new capital flows from abroad will come less freely, with adverse consequences for the dollar and for interest rates.

The second chart underscores the extraordinary nature of our present fiscal position. In only one earlier recession period -- 1975 -- did the Federal Government absorb so large a share of total credit flows, and in every postwar economic cycle, borrowing by the Treasury diminished substantially as a share of total credit flows during the second year of recovery. In contrast, the fraction of credit going to the Treasury, at 35 to 40 percent, will not decline much, if at all, this year from the unusually high level we saw in 1983.

To put the point another way, Treasury debt is expected to increase about 17 to 18 percent this year. Assuming credit grows about 10 percent this year -- just above the mid-point of the FOMC's range -- all other demands for credit could rise by some 8 percent, no more than in 1983 (the first year of recovery). This would be an unusual cyclical pattern.

The Treasury is going to get the funds it needs to cover the federal deficit. The question is whether other sectors will get enough funds, at reasonable interest rates, to support the balanced, higher investment, expansion we want. To some extent, improved profits and cash flow, relative to other recent expansions, could help forestall excessive pressures. But the kind of expansion we and others forsee does imply more business borrowing, and housing and consumer credit needs -- increasing by 11 and 15 percent, respectively, over the last half of the past year -- are already expanding rapidly.

In essence, the demands of the Federal Government limit the rate of growth of other credit-absorbing sectors of the economy. The rationing device is interest rates held higher than would otherwise be the case. Under the circumstances, the more rapidly the economy grows and generates private credit demands, the greater the risk of rising interest rates.

We can, in concept, visualize an economic expansion that continues despite financial strains -- an expansion characterized by relatively high interest rates and by high consumption supported by large deficits, but markedly sluggish investment and a widening trade deficit. That, in itself, is hardly desirable, in terms of the staying power of the expansion and future growth and productivity. But we also have to be conscious of the added risks such financial pressures would pose -- to thrift and other financial institutions, to less developed countries with heavy debt burdens, and their creditors in the U.S. and elsewhere, and to the fabric of international trade. At some unknown point the sustainability of the expansion itself would be jeopardized.

We cannot reasonably escape from these problems by "monetizing" the Treasury debt through excessive expansion of bank credit and the money supply. The Federal Reserve, could, in concept, take an approach which inflated all the numbers, but it cannot increase savings and reduce the savings-investment imbalance by undermining confidence. What must be done is to deal with the source of the problem -- the excessive deficits. While it is already late to make significant changes for fiscal year 1984, action now affecting fiscal 1985 and later years can only work in the direction of moderating potential pressures; if sufficiently forceful, the market could then well anticipate the time the actions become effective. At the least, the risks of eroding confidence and new market pressures should be relieved.

I know you are aware of another reason why expeditious action to reduce deficits is desirable: the large deficits now being projected can be self-perpetuating.

The direct effects are obvious. Interest payments on debt issued to finance this year's deficit add to the deficit next year, and interest payments on those deficits increase exponentially into the future, making it more difficult to reverse the momentum.

Let me illustrate the point somewhat differently. The Administration and the CBO's estimates of the Administration's budget program differ in considerable part because of the underlying economic assumptions used. Specifically, the higher deficit forecasts of the CBO assume that interests rates will not decline as much as the Administration, compounding the effects of higher deficits originating from other factors. But, if we seize the opportunity to take stronger and early positive action to reduce the deficit, and that action helps encourage lower interest rates than projected by the CBO, then the deficit can be placed on a trend more in accord with Administration estimates. In other words, procrastination plainly exacerbates the problem, leaving us all with still more difficult choices not very far down the road.

Somewhat less obvious may be new budgetary pressures arising out of the attempts of various special interests -- consumers, workers or firms -- to offset the effects of sustained high deficits on our international competitive position and on interest rates. For example, the deterioration in the position of our industrial and farm products in world markets is already generating demands for subsidies, tax relief and special protections for economic sectors as diverse as the family farm and the steel industry. The effects of high interest rates on construction and housing costs call forth requests for new programs in those areas.

I suspect all of this is, by now, familiar to you. The real obstacle to action is not intellectual, but the difficulty of reaching a practical consensus on specific spending or revenue measures to deal with the problem. In a sense, dealing with the deficit seems to be everyone's second priority -- the first is particular spending programs or measures of tax relief that, viewed in isolation, have strong justification.

Decisions in those areas -- with political as well as economic dimensions -- are not within the competence of the Federal Reserve. I can only urge that they be faced sooner rather than later before we are enveloped with an atmosphere of crisis, in financial markets and elsewhere.

Much has been achieved in these last few years to put the economy on a sounder footing -- too much, at too great a cost -- to see it all jeopardized now. The risks arise mainly from our own actions -- or inaction. The amounts required to make a real difference -- to bring the trend of deficits under control -- are surely not beyond reach. It has been done in the past, and it can be done again.

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Table 1

Summary of Federal Reserve Monetary and Credit Growth Objectives and Economic Projections for 1984

Objectives for Money and Credit Growth[1]

	New ranges for 1984 (%)	Tentative ranges for 1984 set in July 1983 (%)	Ranges for 1983 established in July 1983 (%)
M2	6 to 9	6-1/2 to 9-1/2	7 to 10[2]
M3	6 to 9	6 to 9	6-1/2 to 9-1/2
M1	4 to 8	4 to 8	5 to 9[3]
Domestic Nonfinancial Sector Debt	8 to 11	8 to 11	8-1/2 to 11-1/2

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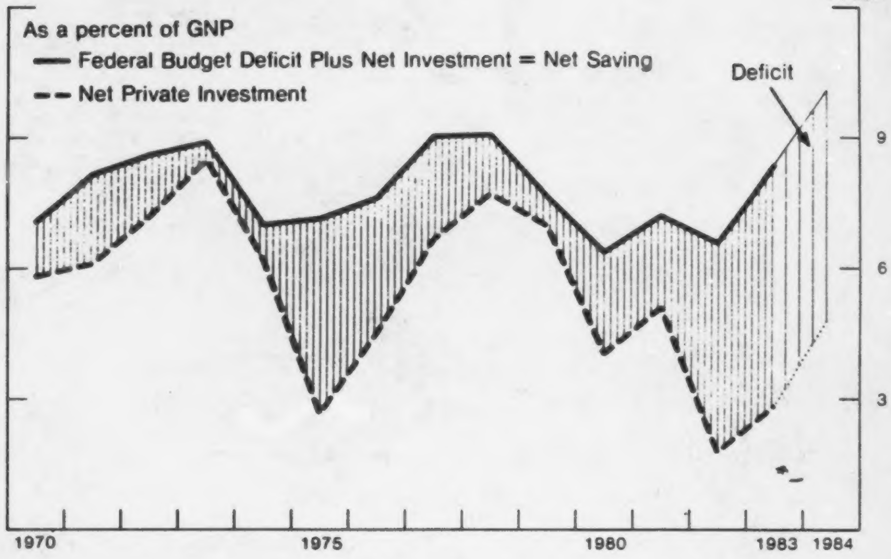
1. Ranges apply to periods from fourth quarter to fourth quarter, except as specified.
2. Range applies to period from February-March 1983 to fourth quarter of 1983
3. Range applies to period from second quarter of 1983 to fourth quarter of 1983.

Economic Projections for 1984

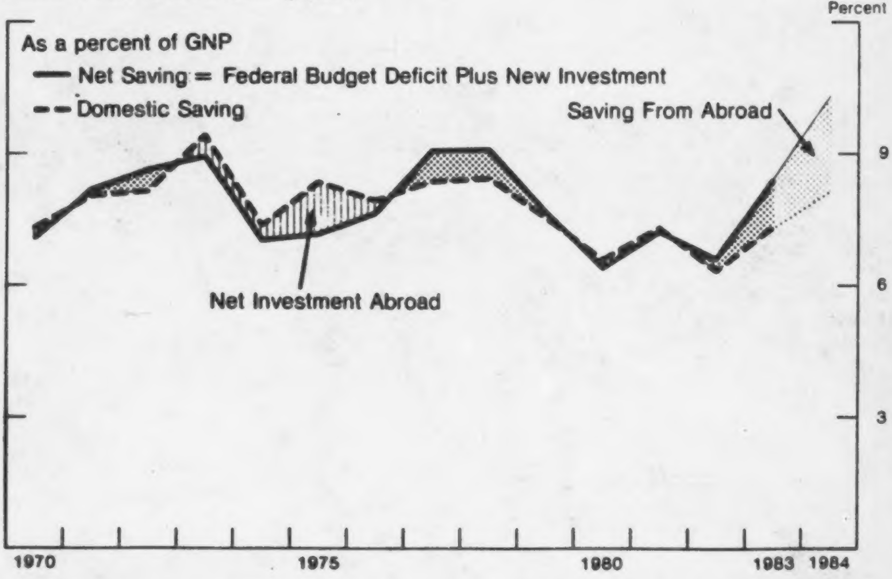
	FOMC members and other FRB Presidents		Adminis-tration
	Range	Central tendency	
Change, fourth quarter to fourth quarter (%)			
Nominal GNP	8 to 10-1/2	9 to 10	9.8
Real GNP	3-1/2 to 5	4 to 4-3/4	4.5
GNP deflator	4 to 6	4-1/2 to 5	5.0
Average unemployment rate in the fourth quarter (%)	7-1/4 to 8	7-1/2 to 7-3/4	7.7

Chart I

Demands on Available Saving (Net)



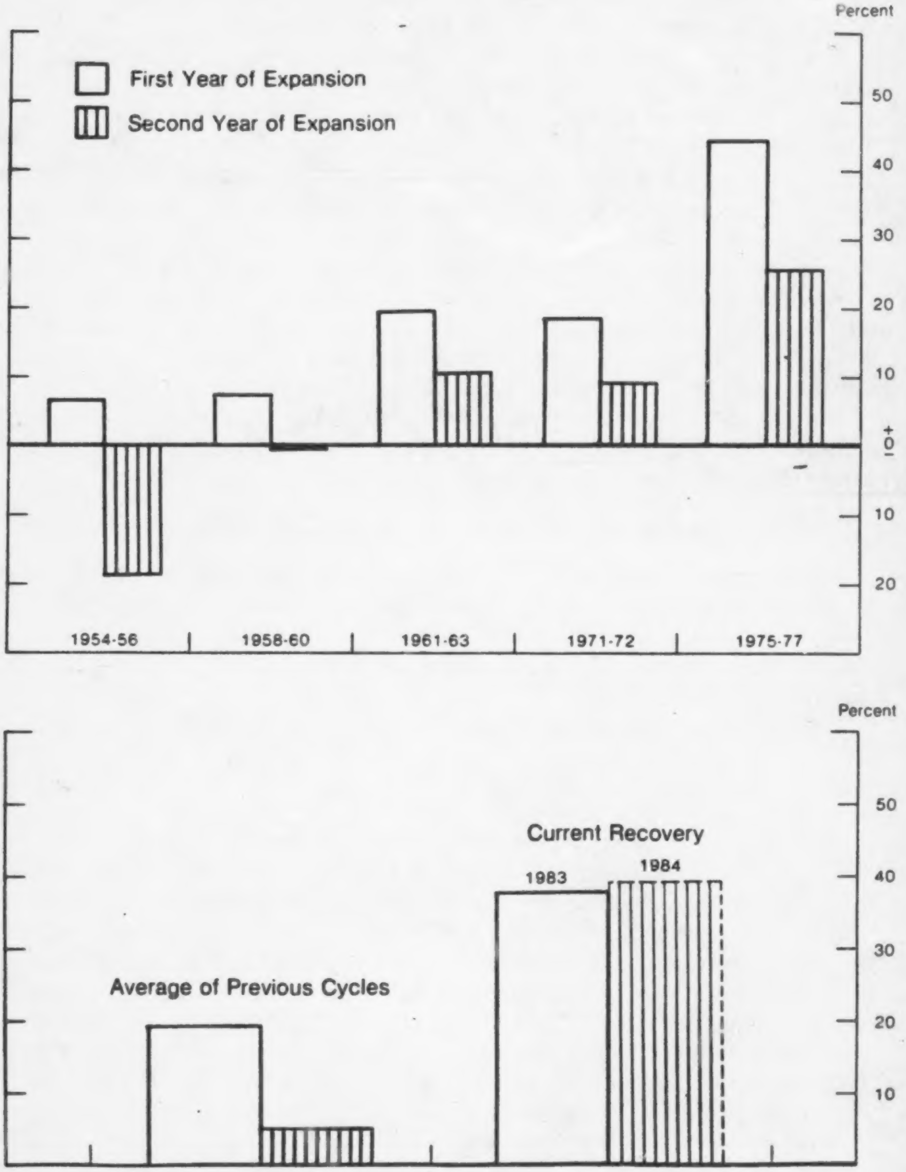
Sources of Available Saving (Net)



Note: 1984 figures based on FOMC members' projections for the economy and estimates of the federal budget. Saving from abroad essentially equals the current account deficit.

Chart II

Share of Total Credit Taken by U.S. Government*



* Net borrowing by U.S. Treasury as a percent of total credit flow to domestic nonfinancial sectors.

CROWDING OUT IN AMERICAN MONEY MARKETS

Chairman **Domenici**. Chairman Volcker, is there any significant crowding out at this point in the American money markets?

Mr. **Volcker**. I do not think crowding out, to use that term—and it may not be the best term in the world—is something that arises one day and announces itself such that people cannot get in or out the theater door. It goes on all the time to some degree.

It has gone on in the past year, it is going on now, in my judgment, in terms of interest rates, which are higher than they would otherwise be; and those interest rates have "crowded out," to use that term, some long-lived investment.

The major and most striking effect in the past year has been that it has crowded out exports and crowded in imports.

Let me look at the economic situation in this way: we have had a good economic expansion as measured by the GNP—something over 6 percent last year. Demand in the American market went up at a significantly greater rate than that; but a portion of that demand flowed overseas and generated incomes and production and jobs overseas, and that is a form of crowding out.

Has it reached acute proportions? I think not, in a sense; the economy has continued to expand. But is there crowding out of some sectors? Yes.

RELATIONSHIP BETWEEN DEFICITS AND INTEREST RATES

Chairman **Domenici**. I think you and I agree. I am trying to make sure that you tell us why interest rates are high. We have had a number of witnesses before our committee this year, and only one administration witness tells us that this was not related to the deficit.

And I think you have generally been saying that if interest rates are going to come down or if they are not going to go up, the deficit has to be addressed. If that is the case, then there must be some relationship. Is that correct?

Mr. **Volcker**. I think there is a relationship, yes. I do not think it is the only factor, but I think there is an evident relationship between deficits of the size and magnitude that we have and what is going on in the economy and what is going on in interest rates.

Chairman **Domenici**. Most of the witnesses have told us that that is the case and that interest rates are high or are not going to come down because of the fear that in the future—and I am not speaking 10 years, but in a span of 5, 6, 7 years—that indeed there will be crowding out of the type you described at the end of your statement. You said there is not critical crowding out.

Is that true? Is that how you see it?

Mr. **Volcker**. Yes. I think the deficit affects the situation. One is more or less directly measurable by the sheer magnitude of the force of demand put on the credit markets, which you can see in these charts in my prepared statement, or otherwise measure—historically very high absolute levels and high proportionate levels. That it is bound to have an effect on interest rates directly.

INTEREST RATES AFFECTED BY INFLATION

But I think another factor bearing upon interest rates is the outlook for inflation, and I think the interest rate structure continues to be affected by the fact that we have gone through years of accelerating inflation. We have had considerable improvement for 2 years, but there is still some concern, nervousness, skepticism about whether that can be maintained.

That climate is, in turn, affected by history, but it is also affected by the budgetary situation because there is a kind of commonsense feeling, based upon a lot of experience over a lot of centuries in a lot of countries, that very large imbalances in governmental budgets sooner or later are accompanied by money creation, heavy pressure on financial markets and inflationary pressures.

So when one talks about the psychological effects on interest rates and the inflationary expectation effects on interest rates, which I think are real, to some degree that also reflects concern about the budgetary problem.

I would also say with respect to interest rates currently that while they are too high in some sense—they are too high for the balance and durability of the recovery over time—it is hard in a narrower focus to say they are too high given everything else that is going on in the economy.

The economy has, in fact, expanded rapidly, despite that level of interest rates because other things are going on in the economy to push it ahead very rapidly. One of those things, of course, is the purchasing power pushed out by the deficit itself. So you get three effects from the deficit.

COMPOUNDING INTEREST RUNS AGAINST YOU

Chairman DOMENICI. You have seen the difference between the 1989 deficit projections of CBO and the administration deficit based on current policy, and I assume you are aware that somewhere between 70 and 80 percent of that difference is attributable to the assumed interest rate on the debt.

Mr. VOLCKER. Right.

Chairman DOMENICI. Have you seen the projections which indicate that if interest rates were to go up dramatically, even if the deficit only went up another $100, $150 billion, or $200 billion, we would end with the composite interest payment per year being almost as large as any deficit reduction we have ever accomplished up here. The deficit would grow more by the increase in interest rates than we have even been able to cut a deficit, even when we have legislated major cuts.

You have seen those numbers?

Mr. VOLCKER. I am generally aware such calculations have been made. I have not looked at them specifically, but I am well aware that the compounding of interest runs against you, and that is why I emphasized the importance of dealing with this as soon as possible.

The earlier we can deal with this problem, the more we avoid that risk. The momentum builds if we do not deal with the problem, and I think that is the point you are making.

POLICY CONDUCTED IN TERMS OF OVERALL ECONOMIC SITUATION

Chairman DOMENICI. One last question, Mr. Chairman. People have from time to time quoted you, appearing at other hearings and in speeches, where it appears that you were almost saying, unless Congress does *x*, I will do *y*, the *y* being some ominous sort of thing that you will do to sort of teach us a lesson; you, may affect interest rates such that we will learn from you.

That is not what you are saying, is it?

Mr. VOLCKER. No. I do not think I have ever suggested anything of that nature. I sometimes get questioned about it, but I have said before and I will say again that we will conduct our policy as best we can, in our judgment, based on what is appropriate in terms of the economic circumstances that exist.

I think it would be entirely inappropriate to conduct policy on any other basis, particularly to design some particular policy action to influence your thinking or the public's thinking or the administration's thinking.

That is not our job. Our job is to make the best judgment we can as to what the overall economic situation requires, which, of course, is affected by the budget situation.

CUTS OF $50 BILLION SHOULD HAVE IMPACT ON MARKET

Chairman DOMENICI. That kind of interpretation has also yielded, at least on my part, a notion that maybe you were saying you had a prescription. For example, unless we do $50 billion worth of absolute cuts for the year 1985, we would not be doing enough, and therefore you would do something.

That is not what you mean either, is it?

Mr. VOLCKER. Certainly, the latter part of that bears no relationship to anything I have said. I have been pressed on a number of occasions as to what is a nice figure you ought to aim for for 1985. What kind of figure, in my general judgment, in the market judgment, would make a real impact on market sentiment, potentially on interest rates, and so forth?

I have cited—partly because it is a nice, round figure—a figure on the general order of magnitude of $50 billion. That would make a very real impact, I think.

Chairman DOMENICI. So if you put it in a 3-year package, that would be $150 billion.

STRUCTURAL DEFICIT IS BASIC PROBLEM

Mr. VOLCKER. Of course, I think as you get out further in years, you have got a bigger budgetary problem than that. I think the basic, underlying problem—the structural deficit—is getting a little worse as time passes, is getting bigger and not smaller.

That is what you ought to be looking at, as best one can judge, in making a medium-term judgment. What kind of a problem have you got? I think in the neighborhood of $100 billion per year, but going out over a period of time. And the earlier that problem begins to be attacked, the easier it is.

Otherwise, it becomes more than a $100 billion problem because of the compounding effect that you were alluding to.

Senator **Riegle**. Would the chairman yield briefly just for one moment on that?

Chairman **Domenici**. I was going to go to Senator Chiles, but I will be pleased to yield.

SIGNIFICANT DOWNPAYMENT IMPORTANT

Senator **Riegle**. I will just be very brief.

When you appeared before the Banking Committee, the numbers that I recall you offering were $50 billion for 1985, $75 billion for 1986, and maybe $100 billion for 1987 as a 3-year target. These numbers may not be absolutely precise, to-the-last-dollar, but——

Mr. **Volcker**. I am sure it was not absolutely precise. I do not recall that precise schedule. You know, I am reluctant, frankly, to cite any particular figure. I am giving you a general notion of what I think, given the situation we are in, would be a kind of ideal approach.

My basic point is that I think it is important to make a significant "downpayment", to use that term—and I think it is only a downpayment given in the kind of numbers we are talking about—but to make a significant move in that direction both because of the value of that move itself—and it has to be significant—and because it suggests that further steps can follow.

$100 BILLION DOWNPAYMENT BETTER THAN NOTHING

Senator **Chiles**. Well, Mr. Chairman, if you can tell us, do you think $100 billion over 3 years is enough to calm the financial markets and to prevent a crisis and significantly diminish the risk of another recession in 1985 and 1986?

Mr. **Volcker**. When you say $100 billion, do you mean for the 3 years combined?

Senator **Chiles**. Yes, for the 3 years combined. I think your staff has handed you a little table that we have put out that shows that if you look at the President's budget, we see, by 1987, the deficits going to $181 billion according to CBO reestimates..

TABLE I.—DEFICIT COMPARISONS

	Fiscal year—			
	1984	1985	1986	1987
President's budget	184	180	177	181
CBO reestimate	186	192	211	233
CBO baseline	189	197	217	245
Percent of gross national product	5.3	5.0	5.1	5.3
A. —$100 billion option		(20)	(30)	(50)
Deficit	190	177	187	195
Percent of gross national product	5.3	4.4	4.3	4.2
B. —$200 billion option		(36)	(62)	(102)
Deficit	190	161	155	143
Percent of gross national product	5.3	4.1	3.6	3.1

Under the baseline figures, if we did nothing, those deficits would be $245 billion. If you save $100 billion, then your deficits would go to $195 billion; it would still be $195 billion. So, in effect, at $100 billion, this would show you that those deficits have actually gone up from 1984.

I want to know is that sufficient to prevent a crisis and to diminish the risk of another recession in 1985 and 1986? And that assumes most of that is going to come the third year.

Mr. VOLCKER. I do not know what particular assumptions lie behind all these estimates. I assume you have not changed the interest rate assumption when you make these estimates.

Senator CHILES. That is right. We are using the CBO economics.

Mr. VOLCKER. Yes, and you are using the same interest rate no matter what you do on the deficit.

Senator CHILES. That is right.

Mr. VOLCKER. I do not know just what the assumptions should be, but it probably is not correct to use the same interest rate assumption regardless of what budgetary program——

Senator CHILES. CBO is showing a declining interest rate in their forecast.

Mr. VOLCKER. Yes, very mildly declining, as I remember it.

Senator CHILES. Right.

Mr. VOLCKER. And, just to illustrate, if you put a $200 billion deficit reduction package on top of what they assume in arriving at that interest rate, presumably you would lower the interest rate.

Senator CHILES. Yes.

Mr. VOLCKER. I would if I were making that projection, and that would make the budgetary picture look better than what you are suggesting.

Senator CHILES. Right.

Mr. VOLCKER. But to answer your question in general terms, obviously $100 billion is $100 billion better than nothing. If that is the choice, it is a substantial improvement from where we are.

The quicker that is effected—and you have got it back loaded, so to speak—the more that could be put in earlier, the better off you are. You would be better with a $200 billion option; I do not think there is any question about that, but I would raise the question of what you can reasonably get. If you end up with a $100 billion option, recognize you are going to have to do more, or should do more, later. But it is you, I guess, that——

FRONT-LOAD PACKAGE AS MUCH AS POSSIBLE

Senator CHILES. If you front load it more, then it grows even larger. I think you are saying——

Mr. VOLCKER. I am saying the more you can do the sooner the better, because it begins compounding in a favorable way because you get the interest rate effects, if nothing else, and you get the subsequent-year effects of whatever action you take.

I would certainly encourage you to focus as much as possible on 1985. You have still got more time to get around to 1987. You will be meeting in this committee and elsewhere upon a number of occasions and can do more.

The most critical action is what you can do on the front end, it seems to me.

Senator CHILES. What is your feeling about what we ought to try to at least get on the front end in 1985?

Mr. **Volcker**. I have thrown out this $50 billion figure—or $30 to $50 billion. But get all you can get.

NO ADMINISTRATION CRITICISM OF FED'S POLICY

Senator **Chiles**. All you can get.

It seems to me, Chairman Volcker, that the administration, perhaps, is setting you up as the fall guy. The President refuses to make any recommendations that significantly reduce the deficit. And at the same time, it appears to everyone else that he wants you to ease monetary growth to get the rates down.

If the rates go down, of course, that is good for the President. If they do not, then you are in the doghouse. Is the administration supporting your current posture or are they asking you to ease up?

Are they saying you have to be easy enough to meet their optimistic growth projections?

Mr. **Volcker**. I have conversations on a continuing basis with people in the administration, as you know. I think they have said publicly they do not seem to find great difficulty with the targets that I referred to this morning.

Election years are nervous and difficult times, as you know, in political life generally. But I do not think in those conversations that I have had directly with them there has been any particular criticism of policy—certainly not of those objectives as set out.

CONTINUED ECONOMIC GROWTH POSSIBLE THROUGH 1984

Senator **Chiles**. Do you think that under the objectives that you have set up, if we do nothing on the deficit reduction side, we will be able to continue the economic growth projections?

Mr. **Volcker**. I think the economy has a lot of momentum at the moment. I think the outlook for interest rates over this period is influenced importantly by the strength of the economy generally, because out of that is generated private credit demands, adding to the budgetary credit demands.

I think it is entirely possible and probable that economic growth will continue through 1984, but what I would emphasize is that with each passing month we take more and more risk of problems arising from several directions. We have got all those risks tied in with the growing trade deficit, which most people estimate at $100 billion or more this year. We had a bad trade deficit figure announced this morning which amplifies the point.

I do not think that is sustainable indefinitely, but I certainly am not going to say that it cannot continue for another year or longer. It is not the kind of thing from which you can expect a collapse or a great interruption in the short run.

This current constellation of events and policies puts unnecessary, undesirable pressure on the whole international financial system, particularly that part of it tied up with financing developing countries. That problem is not over by any means. It would be greatly assisted if we could more clearly look forward to a decline in interest rates.

We have large and potentially increasing risks in that area. We also have the problem that domestic investment is not rising—at least certain types of domestic investment are not rising. Again, certain types have been rising quite rapidly, but the kind that is necessary to support capacity increases and productivity increases over a period of time are rather sluggish. That is a risk to the economy.

I do not think anyone can sit here and predict that this is going to culminate in a crisis during the course of 1984, but the longer it goes on, the more difficulties.

APPRECIATION OF DOLLAR

Senator Chiles. Mr. Chairman, the dollar has increased in value between 40 to 50 percent since 1980. Do you agree that the appreciation of the dollar is primarily a result of the high real interest rates, and that those high real interest rates are directly related to the huge Federal deficit?

Mr. Volcker. I think the interest rates are one factor, and the interest rates, in turn, are partly related to the budgetary problem. I think there are other factors in that situation.

In relative terms—and that is what exchange markets have to deal with—the United States has looked like a pretty good place to keep money for a variety of reasons.

Politically, when disturbances or questions arise abroad, money tends to come to the United States. Economically, we have made a lot of progress, and particularly on the stability and price front. I think that has encouraged confidence, encouraged money flowing to the United States.

There are other factors apart from the interest rate factor, but the interest rate factor is not unimportant. I think our economy has been growing more rapidly than others, and that has attracted money. The stock market has done well, reflecting that.

Other countries have been, in effect, generating more savings than they have been using internally, and those savings have been available to us. Many of those situations are subject to change, and part of what we are dealing with is maintaining the relative confidence that we have enjoyed, because we have to count on that money continuing to come in for the time being; we have no choice. It is going to have to continue to come in because it is the only way we can finance the deficit and the investment we need.

FOREIGN CAPITAL FROM THE STANDPOINT OF DEVELOPING COUNTRIES

Senator Chiles. Right now, this is a way in which we are financing the deficit. But the other side of the coin is that other world economies are just starting to recover, and here we have this magnet for foreign capital. What are the harmful effects of that on the growth and development processes of the less developed and underdeveloped countries, some of which have huge bank loans. Are we risking our future and theirs by relying so heavily on this foreign capital?

Mr. Volcker. Yes, I think we are. Now, there is kind of a classic good news-bad news situation in the short run because our sharply increasing imports have been of assistance to foreign countries in getting their own economies started.

And, in fact, we have absorbed directly a lot of the reduction in imports, reflected in reductions in our exports to some of these developing countries that have had severe adjustment problems; we have been able to absorb, to a degree, their adjustment.

But as foreign economies grow—and they are beginning to grow more rapidly, I sense, now—the adverse effects that you referred to clearly become predominant. They are going to need their savings at home as their own investment gets started; and, when one looks at it from the standpoint of the developing countries, anything that tends to push up dollar interest rates presents very severe problems to them.

That is a major obstacle to prospects for getting through this period in an orderly way, and that is the risk that I referred to earlier.

Senator **Chiles**. Mr. Chairman, that is all the questions I have.

Chairman **Domenici**. Thank you very much, Senator Chiles.

Senator Quayle?

MOVE PROCESS OF DEFICIT REDUCTION PACKAGE

Senator **Quayle**. Thank you, Mr. Chairman.

Chairman Volcker, I was glad to hear you tell Senator Chiles that a $100 billion deficit reduction package is better than nothing because I feel that that is correct. I also think it is somewhat different than the press reports today where they publish that you warned that the $100 billion deficit reduction package would not alleviate any of the financial concerns in the market.

To me and to a lot of people, that just undercuts a lot of the momentum that is going on on the deficit reduction package. I hope that comes through louder and clearer—that a $100 billion deficit reduction package is better than nothing because I think if we have the kind of statements and the argument back and forth of whether it is going to be $100 billion or $150 billion or whether you are going to have $50 billion in the first year or $75 billion, or $100 billion next year, it is going to be very counterproductive.

I think you know this, and I certainly tell you that all of us appreciate the importance of the Chairman of the Federal Reserve. And that kind of publicity, from my perspective, is not helpful.

I was just reading it this morning, and I just encourage you to amplify on the response that you gave to Senator Chiles that even though we may not be able to make significant reductions this year for political reasons and perhaps other reasons, that we had better get started.

I also believe what you said that, in fact, we ought to get as much as we possibly can. I do not dispute that, but I just encourage you to try to move the process of the deficit reduction package along because if we have this argument and this continued debate, I am fearful that we will not have anything, and I certainly support the idea that the $100 billion is better than nothing.

IMPACT ON MARKET FROM $100 BILLION PACKAGE

Mr. **Volcker**. Let me perhaps try to clarify what I said yesterday in responding to the question. I think I said essentially the same thing this morning.

I was asked the question, as I recall yesterday, what kind of an impact would you expect to get on the market from, I guess, a $100 billion package. I said that would depend upon how it is structured, in part.

If it is all put in very vague terms out in 1987, do not expect a big impact on the market, because it will not be very credible; do not expect drama from a nondramatic, questionable program.

What I was trying to emphasize is that the more that comes early in hard deficit savings, the bigger the impact you are going to have, and I would want to emphasize that again.

Senator **Quayle**. Well, I do not dispute that. The bigger the impact we have this year, the bigger the impact we are going to have in the markets.

But, you know, as friendly advice—you have to put up with it in this committee and other committees. Where you say, well, this particular package is not going to have this or that kind of an impact.

On the other hand, you could say a deficit reduction package has got to go forward. A deficit reduction package will have impact; it depends on the makeup of the deficit reduction package.

I think that would be a much more helpful comment in trying to get something done this year, which is going to be exceedingly difficult. As one who is interested in this, I would encourage you to speak more in that kind of vernacular than some of the statements that have been attributed to you, at least in the press, and particularly today's press.

Mr. **Volcker**. What I was surprised at in today's press is that they all took that as a comment on some program that was under consideration. That was not the question I got.

Senator **Quayle**. Well, OK.

Mr. **Volcker**. The question was: What kind of an impact are you going to have on the market? And I said it depends upon how it is put together.

RISK OF INTEREST RATES GOING UP

Senator **Quayle**. Well, whether you like it or not, your statements have a big impact on the market, at least according to this—a psychological effect.

Let me just get into a couple of other areas here. You were talking about the risk and, as you said, we may have the growth to get us through 1984, but you went on and said that domestic investment is not rising and that the crisis goes on, that there are problems.

Let us assume something less than significant is, in fact, done by the deficit reduction package, but that a deficit reduction package goes forward. These risks seem fairly high to you.

Do interest rates have a good chance of going up this summer or late third quarter, first part of the fourth quarter?

Am I misreading the calculations of the risk that you proffer?

Mr. **Volcker**. I think if the economy is exceptionally strong, that risk obviously exists. If the economy is weaker—weaker in terms of less rapid increase—the prospects for interest rates would be better.

But I think the only way for you to assess this is to say those possibilities always exist. Where are you tilting the scale with your budgetary actions? This kind of deficit clearly keeps the interest rates and the risks greater than they would otherwise be.

That is the policy variable that you can deal with and that the Government can deal with generally. That is where we ought to be working. Basically, we are in an environment where it seems to me that, given the inflationary trend today—given what I conceive to be the inflationary outlook if we do our job—interest rates are not only historically high, as a factual observation, but they ought to be coming down; and that would be healthy for the economy from many dimensions.

But what are the prospects of them coming down? Are they very good when you have got this kind of budgetary situation, or have we not, in fact, created the situation where there is a risk of them going up? I think the answers to those questions are obvious, and that is part of the risk to which I allude.

Senator **Quayle**. My time is up, but that is what you are sort of saying to me. If you put in the assumption that we will do something less than significant, but something on the deficit reduction package, you are really, in effect, communicating that the risks are going to be so great that there is going to be upward pressure and not downward pressure on interest rates.

Mr. **Volcker**. Right. I am not forecasting that, but you are increasing the risks of it, yes.

Senator **Quayle**. Yes; and as you increase the risks, then I can read into it that you are increasing the potential of pressure on the upward——

Mr. **Volcker**. No question; you are increasing the pressures on the market.

Senator **Quayle**. Well, that is the message that you are giving to me, and I know you do not want to forecast that.

Mr. **Volcker**. No; I do not want to——

Senator **Quayle**. I certainly hope that you do not. My God, I would hate to see the stock market if you started forecasting that interest rates are going to go up.

Mr. **Volcker**. I do not want to forecast that.

Senator **Quayle**. But I certainly think that the message is there.

Mr. **Volcker**. I do not want to forecast that.

Senator **Biden**. You had better stop talking, then. [Laughter.]

Mr. **Volcker**. I will stop.

Chairman **Domenici**. Are you finished?

Senator **Quayle**. Yes, Mr. Chairman.

Chairman **Domenici**. We will strike all that from the record. Senator Biden.

Senator **Biden**. Dan, I hope you are not offended. I was joking. I did not mean you should stop talking because of the time; I meant you should stop talking because you are right and the exact thing you are projecting is going to happen.

And if we do not want everybody to know that—but everybody is smarter than we are anyway.

Mr. **Volcker**. I am not forecasting higher rates.

Senator **Biden**. I know you have not said a thing, Mr. Chairman; I know that.

Mr. **Volcker**. But I sure think this budgetary situation does not help.

SUSTAINED RECOVERY WITHOUT DEFICIT REDUCTION POSSIBLE

Senator BIDEN. I think that may be the understatement of the year.

Mr. Chairman, let me pursue the issue that has been pursued by my three previous colleagues in a slightly different way. Can economic recovery be sustained in 1985 if we do absolutely nothing about the deficit, if we just let things go along as they are and we just do not do anything?

Mr. VOLCKER. Are you asking is it possible? Yes, of course it is. Let me try to amplify the answer this way: if you take econometric equations of many stripes that economic forecasters use, and you plug in this kind of a Federal deficit and you plug in other kinds of assumptions, what it tends to show is the economy will continue growing. It will be a relatively high consumption economy; it will be marked by very large trade deficits. It will be marked by difficulties in housing and sluggish long-term investment. These kinds of models continue to show growth, but in a high-consumption economy, an economy that does not look very good for productivity, an economy that looks terrible from the side of the external sector.

Typically those models do not show the risks and problems that are involved. If you superimpose upon that kind of projection the kind of financial and real problems that would be aggravated over this period of time, then month by month, the risks of "accidents," if I may put it that way, multiply.

Those accidents could arise out of the international financial situation; they could arise out of the foreign equation; they could arise out of the market anticipating pressures and pushing interest rates up higher than those models would suggest, and causing an interruption in economic activity.

Those risks increase over a period of time. Our thrift institutions in a much better position now; they are breaking even; they are making a little money. But they could easily be thrown back in a loss position because of the very weakened position developed over earlier years, if interest rates went up significantly.

That is not taken account of in any economic model, but it is a fact of life, and it is not good for the sustainability of the recovery. What do we need for a sustainable recovery? We need a lot of investment, we need more productivity, we need to straighten out over time this international imbalance.

The kind of economy that you are projecting, while it may continue to grow, does not do any of those things, so it is not good for long-term sustainability.

NEED BICAMERAL CONSENSUS

Senator BIDEN. By the way, we are talking here a lot on the Hill and in Washington about the need for a bipartisan consensus to deal with the deficit downpayment, et cetera. I would think the more accurate way to characterize it is we do not need a bipartisan consensus; we need a bicameral consensus.

And one of the bodies is not the House; it is the Congress and the President. I find more agreement among Democrats and Republicans up here on a willingness to do something about this than I do between the Congress and the President.

I have not heard any suggestion on the Hill from Democrats or Republicans—there probably have been some, but I just have not heard them—but any suggestion that we can deal with a deficit reduction package, to use the phrase used these days, without dealing with revenues.

And several witnesses have suggested that there is little or no difference in dealing with deficits by increasing taxes or by continuing to borrow, and they argue that there is not any difference in terms of the impact on the economy. Do you share that view?

Mr. VOLCKER. No.

Senator BIDEN. That is a good answer, and straightforward. I am so unaccustomed to getting a one-word answer from anyone that I am a little shocked. Now, let me go to the next question. [Laughter.]

Mr. VOLCKER. I might——

Senator BIDEN. That is good. Stop right there; you are doing fine.

Mr. VOLCKER. Let me amplify with one sentence. I think it makes a good deal of difference what kind of taxes you are talking about.

Senator BOSCHWITZ. I am waiting for a one-word question.

Senator BIDEN. Why? Is that good?

Senator BOSCHWITZ. Yes, that is fine.

DIFFICULT TO CUT $50 BILLION FIRST YEAR

Senator BIDEN. All right. My time is about up. One last question: the $50 billion figure you mentioned—and I realize that there is nothing particularly firm about it but the notion of $50 billion in the first year.

The point that Senator Chiles was trying to make—and I want to make sure I understand it—is to come up with $50 billion in cuts this year, you are talking about——

Mr. VOLCKER. "This year" meaning next year.

Senator BIDEN. Fiscal year 1985; for this budget, I should say.

To come up with a $50 billion cut for the fiscal year 1985 budget, you are talking about somewhere in excess of $250 billion for a 3-year package. I do not know of any way you get $50 billion this year that you put in place.

Let us say you cut defense—you cannot—$50 billion this year. You are talking about cuts for the next 3 years that exceed $250 billion.

Chairman DOMENICI. Right.

Senator BIDEN. And so I guess the point I am trying to make is that we really ought to understand how difficult it is to get $50 billion this year. Quite frankly, I think that is what this is all about—and I think the President really knows exactly what he is doing.

We are going to get through this thing this year. The economy is probably going to, you know, make its way through and then the President is going to get exactly what the budget has been all about, which is a social document, and the aim is, in my view—and I know I am going to get a lot of hue and cry here—but to fundamentally cut the entitlement programs.

And next year, no one is going to be able to do anything, Democrat or Republican, except say, we are in trouble; we either need massive taxes or massive cuts in entitlements; we are going to have to do both. And that is what is going to happen.

I hope it can be avoided because we are going to do it out of that—and that may be, you know, what some people think is a good idea. But I just do not see how you get $50 billion this year unless you are talking about a package of something in excess of $250 or $300 billion.

Mr. VOLCKER. I do not know about that, but I recognize that it is hard, particularly on the spending side, to make abrupt cuts, and that is what is going to limit what you can do practically. I just want you to aim as high as you can in the first year, because that is where the impact will come.

Senator BIDEN. I agree with you.

Mr. VOLCKER. Let me say that deferring the whole thing for another year means we are talking about 1986.

Senator BIDEN. You are right.

Mr. VOLCKER. And you are going to say the same thing then, that it is hard to make the cuts initially.

Senator BIDEN. I agree. If you cannot do it when there is economic growth, what happens when we are in a situation where there is a turndown in the economy? I could picture a $400 billion deficit.

Mr. VOLCKER. Meanwhile, all those risks to which I refer, mount as time passes.

Senator BIDEN. I agree. Thank you very much, Mr. Chairman.

Chairman DOMENICI. Senator Boschwitz.

FOREIGN CAPITAL OUTLOOK

Senator BOSCHWITZ. Mr. Chairman, I wanted to ask you about the foreign dollars or the foreign capital that comes into this country. You said earlier on that it has to continue to come in.

I would like to ask you what you see as the outlook for that. And, of course, if it does not continue to come in and there is a lessening of demand for dollars, I presume the value of the dollar will go down, which will cheapen our exports.

Mr. VOLCKER. The dollars will come in because we have no choice; they have got to cover the trade deficit and the current account deficit. The question is on what terms do they come in; at what level of the dollar, at what level of interest rates?

That is a major vulnerability as we move ahead. If there is a loss of confidence or loss of incentive to put dollars in the United States, you are taking risks on the exchange rate side, you are taking risks on the interest rate side.

It is not just that the dollars have to continue to flow in at the same rate of speed as in 1983; they have got to flow in at twice that rate, or 75 percent greater, because the deficit is getting bigger.

As the figures this morning suggest, with the trade deficit getting worse—I hope that is an exaggeration of the trend, but it is indicative of the trend that we have been on—we constantly have to import more capital to cover the growing deficit in our external accounts.

The only thing at issue in the short run is what terms and conditions that money comes in on. So far, we have been exceedingly fortunate because foreigners have happily and willingly wanted to put their money in the United States. Suppose we have to fight for it? We have not had to do that.

Senator **Boschwitz**. For a variety of reasons.

Mr. **Volcker**. For a variety of reasons; that is right.

Senator **Boschwitz**. Do you foresee that those reasons will continue?

Mr. **Volcker**. It depends upon how we conduct ourselves. One of the reasons they have been coming in, I firmly believe, is faith in the stability of the United States. There has been a good feeling about our economic expansion.

Now, if you remove the two props—if monetary policy is interpreted as inflationary or, worse yet, is inflationary; if there are doubts about our sustainability of our economy, and whether the United States is a good place to invest—then we have got problems.

I think all those things are at issue in terms of the budgetary situation.

Chairman **Domenici**. Would the Senator yield?

Senator **Boschwitz**. Yes, Mr. Chairman, I yield to this chairman up here.

FOREIGN CAPITAL—INFLOW VERSUS OUTFLOW

Chairman **Domenici**. Well, allow me to ask this question to follow up on what you just said.

Chairman Volcker, I understood you to say in Miami when you were there with Senator Chiles and I on this issue of inflow versus outflow—I understood you to say that while this was something very unusual and very high—that is, the amount of foreign capital that is here—that you thought it could probably reverse itself in a very orderly manner with very serious negative effects. In other words, as the world marketplace got better, the inflow would be less.

But, conversely, the overall situation could cause us to do better in the world market, and maybe interest rates would then come down and everything would grow at a little better rate than it is.

Mr. **Volcker**. That is what we would love to see happen. You have got to find the key to make that possible. Over time, sooner or later, we are going to have to reduce this dependence on foreign capital. It is not a sustainable situation. We cannot run deficits of this size forever, because it is inconsistent with the confidence that is necessary to induce the inflow; so we are just talking about when.

We want to see this happen in an orderly manner and in as constructive a way as possible, and I think it is possible to visualize that happening over time in a constructive way. What does it take to be constructive?

Right now, if one could imagine that the capital inflow were shut off, you immediately have to ask yourself how can we finance the deficit plus our investment needs? We have not got enough savings here; there is no prospect we are going to have enough savings generated domestically to cover the deficit and our investment needs right now.

If that happened under those conditions, you have very adverse impacts potentially for interest rates, as well as for the exchange rate, which adds to inflationary pressure. If, instead, we take the initiative, we reduce the demands on our own market—we are no longer so dependent upon those capital inflows; then they can subside over a period of time so that foreign countries can employ their own capital at home, assist their own growth.

That will help our exports, and the situation can evolve in a nice, orderly, constructive way. But that is all dependent, as I see it, on relieving the pressures and demands on our own market which are now, in a sense, dependent upon a capital inflow.

In that sense, we are a hostage to these continuing capital inflows. We want to get ourselves in a position where we are no longer a hostage; where the inflows to us can subside and help the world economy.

SLOW GROWTH OF FEDERAL SPENDING TO 5 PERCENT

Senator BOSCHWITZ. Mr. Chairman, it goes back to me, I guess, and the plans that are being put together, as I observe them—I read this morning an article in the Washington Post about one that the chairman and I have discussed—are that a several-year plan may be put together.

We have a process here in the Budget Committee, as you are well aware, called reconciliation, about which you and I have talked. And in the event we put together a several-year debt reduction plan, without putting numbers on it—this morning, I noticed in the newspaper that it was $120 billion over 3 years.

In the event that were done, the growth rate of the Federal budget would be about 5 percent a year, which is a fairly decent figure; it is a fairly low rate of growth.

Mr. VOLCKER. In expenditures.

Senator BOSCHWITZ. In spending; that is correct.

Chairman DOMENICI. Yes.

Senator BOSCHWITZ. In the 1970's, it was almost entirely, after the first 2 years, in double digits; even in 1 year, 21 percent, another year 18 percent. So if we bring the growth rate of the Federal budget down to 5 percent per annum, that is quite an achievement.

As a matter of fact, when I came on the Budget Committee, it was growing at 18 percent in the 1980 budget, 14 percent in 1981, 11 percent in 1982, 9 percent in 1983. We are talking about approximately 7 percent in the request this year.

If we bring them down still further to a 5-percent growth each year, I think that the Budget Committee and the Congress have shown a considerable degree of discipline. Exactly where we are going to cut it is a different matter, but I agree with you that it is not important where we cut it; it is just important that we do indeed cut the rate of growth.

If we put that together and then we impose reconciliation so that it is locked in place for a 3-year period, I think that this committee or the Congress will have done a responsible thing.

What would be the impact in that case on the interest rates and on the economy; rather than looking at whether it is $100 billion or $150 or $200 billion, but rather if the growth rate of spending is down to 5 percent per annum?

As we have also discussed, in the last 25 years the growth rate of income in the Federal Government has been about 10 percent. And you pointed out to me that you had to have a rather high degree of inflation to have a 10-percent growth in income of the Government.

I have found that even in years when there was a very low degree of inflation, still it was about 9.6-percent growth per year.

What impact would it have if we are able to slow the growth of Federal spending to 5 percent per annum and lock that in through reconciliation?

Mr. **Volcker**. I do not think I could answer that question intelligently without looking at some of the arithmetic—what the revenue growth would be over this period and how fast that would have an impact reducing the deficit. Obviously, I do not know what inflation rate you are assuming.

I assume that 5 percent would mean that budgetary expenditures are growing 3 or 4 percent slower than the GNP in nominal terms. I think it is obviously an improvement, but I just do not want to make any judgment as to how significant an impact that would have without having a chance to look at the arithmetic.

Chairman **Domenici**. Senator, your time has expired twice.

Senator **Boschwitz**. Sometimes it is easier to slow the percentages.

Mr. **Volcker**. I hope you end up slowing the percentage, but as to what arithmetic result that gives in terms of the budget and giving you some judgment of the impact, I would have to look more closely.

Senator **Boschwitz**. We will get together and talk about it again.

Thank you, Mr. Chairman.

Chairman **Domenici**. Senator Riegle.

CIRCUMSTANCES UNDER WHICH FOREIGNERS WOULD WITHDRAW CAPITAL

Senator **Riegle**. Thank you, Mr. Chairman.

I want to follow up on the problem of foreign capital coming into the country which you were commenting on yesterday. You have repeated the concern today that we are really a hostage to this flow of foreign saving coming in here. You are quoted in the paper as having said yesterday that you did not know if that is a crisis situation today, but it could easily become one.

I am just wondering. Can you help me understand a little better the circumstances under which foreigners would, say, start to withdraw this capital and what would be the process by which this thing could reverse itself and suddenly create a whole new difficulty for us that we have not yet had to contend with?

Mr. **Volcker**. Foreigners as a whole cannot withdraw the capital without us running a current account surplus. In the end, the accounts have to balance, and if we are buying more abroad than we are selling abroad, we have to pay that bill somehow; the only way we can pay the bill is by borrowing.

Those figures do not change all that fast. We can change the trend, but we are going to have a sizable deficit in 1984 so we are going to have to end up borrowing.

What you are really asking is how willingly are foreigners going to provide that money? If they demand a very high return, you have to pay it in the end.

Senator RIEGLE. So in other words, the form it would take is that we would still borrow their money, but we would have to pay a higher and higher rate of interest for it.

Mr. VOLCKER. That is one of the dangers, yes.

Senator RIEGLE. Have we seen any evidence of that as yet?

BENEFITS OF CAPITAL INFLOW

Mr. VOLCKER. No; I think the money has come quite freely. That money certainly keeps our interest rates lower than they would otherwise have been. We have enjoyed the benefits of this capital inflow because it has come so easily. We have enjoyed it in a number of directions. We have enjoyed it in terms of lower interest rates than we otherwise would have. We have enjoyed it in terms of helping inflation.

It has provided a lot of television sets and cars and steel and other things for American consumers. The obverse of that, of course, is that it has not been very good for the industries dependent upon foreign trade or competing with imports.

It has pluses and minuses, but it is easy to enjoy it while it comes freely.

INTEREST RATES EDGING UP

Senator RIEGLE. Has there not been something of an uptake in interest rates recently though? I mean, have not the markets been edging up interest rates?

Mr. VOLCKER. In the last 2 weeks interest rates have tended to go up some, yes.

STOCK MARKET DOWN SUBSTANTIALLY

Senator RIEGLE. And it seems to me that at the same time, of course, the stock market very visibly has gone down quite substantially. There have been a couple of up days, but the general trend has been down sharply.

I am wondering. What do the financial markets seem to be expressing here? I mean, I am thinking both in terms of this upward pressure on interest rates that we are seeing and also what seems to be happening in the equity market. Is there any conclusions what might we draw from this? Is this a reflection that this situation is worsening on us?

MARKETS REFLECTING DEGREE OF UNCERTAINTY

Mr. VOLCKER. Fortunately it is not part of my job description to have to provide instant analysis of why the stock market went down yesterday or will go up tomorrow, but I do think it is fair to say, in very general terms, that those markets must be reflecting a degree of uncertainty about the future.

They are always trying to forecast the future, and I would presume they are reflecting some of the concerns that were expressed around this room this morning and elsewhere.

NO HAVEN FOR FLIGHT CAPITAL

Senator RIEGLE. Some people think that the foreign capital will come in even without a higher interest rate premium because some of it is flight capital and that there may not be a better haven around the world for parking surplus funds than in the United States.

To what extent would you agree that that is so? Perhaps in the end we would benefit, in a perverse way, because even though they might want to draw the money out or insist on a higher interest rate, there may not be a safer place to park the money.

Mr. VOLCKER. I think that kind of consideration has undoubtedly been a factor. I think the question is how much do you want the economic future of the United States at the mercy of that kind of situation.

It may continue. It may continue for a year. It may continue for 2 years. It is going to continue in increasing amounts, because we are more and more dependent upon foreign capital flows, but I do not think it is a very prudent policy to conduct our affairs and run budget deficits on the expectation that we are going to be a haven for flight capital.

Senator RIEGLE. Well, I agree with you.

Mr. VOLCKER. Ultimately, there is some inconsistency in that, because they may begin questioning our stability if the deficits get big enough long enough.

PLACES FOREIGN CAPITAL MAY RETURN TO

Senator RIEGLE. I wonder, if that were to happen and the money were to leave, where would it go? Does it go to places like Switzerland or nations that seem to be better insulated against some of these economic shock waves?

Mr. VOLCKER. In one sense, the desirable place for a lot of it to go would be back to where it came from. I am thinking of the countries of Latin America which, quite generally, have had their problems aggravated by the fact that their citizens put money in the United States or elsewhere—a large proportion in the United States.

It would be a sign of returning health and confidence on the part of those countries if some of their own citizens took their money back home and began investing it productively at home. That is where you would like to see it go.

Senator RIEGLE. Although as we have tracked through before, it seems to me that unless we deal with the fiscal problem here and get the deficits down and in so doing help create some easing on the interest rate in response to a better more restrained fiscal policy, we are going to continue to attract that money, it seems to me, for two reasons. First, because our interest rates are comparatively higher and also because we have this extra bonus of being a safe haven or at least thought of as one.

Mr. VOLCKER. We may continue to attract it, but I do not think it is in our interest to continue to attract it on the basis of higher interest rates, which are undesirable in terms of the American economy. That is the situation we are getting ourselves into.

DEFICIT REDUCTION TARGETS

Senator **Riegle**. Let me just cover one more thing if I may.

Chairman **Domenici**. Sure.

Senator **Riegle**. And I will hurry.

When we discussed this in the Budget Committee, in terms of trying to figure out what we should set as deficit reduction targets, you volunteered the target figure of $50 billion in 1985. That would be your number of preference, recognizing that it is politically difficult and that the longer we wait, the harder it is and so forth.

Chairman **Domenici**. You said Budget Committee. You meant some other committee?

Senator **Riegle**. I meant to say Banking Committee.

And then you used the figure of $150 billion as a ball park number as a deficit reduction target toward the end of the decade. That is how we then try to sort of put in the in between years because we do a 3-year budget plan here. We arrived at numbers that looked like $50 billion, $75 billion, $100 billion for 1985, 1986, and 1987. And then leading on out to the end of the decade to something like $150 billion.

But I think if we can stick with numbers that are somewhat like that, if that constitutes a fair estimate as to the magnitudes that we should be seeking both in terms of an adequate enough bite in the first year—$50 billion—and increasing as we go out. If this is the best judgment as to the kind of path that we ought to try to put ourselves on, then I honestly believe we will have more luck getting there if we are forthright about saying so.

I think if we are not, if we fuzz it off, then I think it makes it a lot easier for everybody to head for the exits and we are likely to get nothing done.

So those were the numbers we developed, and if you feel comfortable with them, I think we ought to try to stick with numbers like that. If there are other numbers you like better, then let us use those instead.

Mr. **Volcker**. I suppose you extracted numbers like that out of me in the earlier hearing, but I just have to say that I am very reluctant to give a particular number as you get out further.

It is just an illusion to think we can judge very closely what the needs will be in 1989. We know that they will be less the earlier we get to work on this problem. This evolved originally not just in that hearing but elsewhere, when I was asked to throw out a number that I was pretty sure would have an immediate, clear impact on market sentiment and therefore on market developments and on economic developments. That is where that nice round figure of $50 billion originated.

Senator **Riegle**. I think it is a good number.

Mr. **Volcker**. I think it is a good number from that standpoint. It is a nice number in terms of making an impact and clearly showing what direction you are going in, showing a very forceful kind of action; but I do not want the best to be the enemy of the good. Certainly a program short of that would be good, recognizing you can come back and improve it in later years; what you can do.

Senator **Riegle**. I understand. I appreciate your patience, Mr. Chairman.

Chairman **Domenici**. Senator Exon.

$100 BILLION DOWNPAYMENT OVERSOLD

Senator **Exon**. Mr. Chairman, thank you very much.

Chairman Volcker, welcome. Thank you for coming here. It must not be any fun to testify in front of committees but I want to tell you that as far as I am concerned, I think the period that we are going through right now and the help that you can give us hopefully is critically important because I think you are familiar with the fact that this committee, which has a very tough responsibility, has received terribly conflicting information from the Director of the Budget, the Secretary of the Treasury, and the Council of Economic Advisers, all representing the administration.

And since I think it is quite clear that we today have a complete and total vacuum in sound budget leadership from 1600 Pennsylvania Avenue, the only game in town to lick the problem that we all seem to recognize, except some who live at 1600 Pennsylvania Avenue, is between the Fed and the Congress.

We just got to do something. I want to just give you a little free advice also. I hope and I do not think you will become a party to a downpayment philosophy that $100 billion is better than nothing.

I think this $100 billion is one of the most oversold things that I have ever heard. Many people out there have come to believe that this downpayment, this new buzz word, means $100 billion off the deficit right away, and since the President says the deficit is $180 billion. We take off $100 billion. It is going to leave $80 billion. We are making great progress.

I honestly feel that this whole situation of using buzz words and mirrors to indicate that we are doing something for election purposes and for election purposes only is the worst possible service that we could perform.

FARM VALUES DOWN

Now, I was particularly glad to see in your opening statement that you addressed the matter of agriculture. I think it is not known inside the beltway the tremendous serious situations we have in agriculture today, the worst frankly that I have ever seen, and I have been closely connected with it all my life.

You are familiar, I suspect, with the plunging of agricultural values which is, for the most part, eliminating the solvency of our family-sized farmers to produce out there. You are familiar, I hope, with the fact that farm values are down, and now the banks are becoming very concerned. How familiar are you with that?

Mr. **Volcker**. I have some familiarity with those problems. I have the impression now, Senator, that it is much more uneven than it was a year or two ago, that those farmers affected by drought and relatively heavily in debt—which tends to mean the newer farmers, I suppose—are under particular strain, whereas in other geographic areas where they had good crops or benefited from the PIK program last year, they have been able to stabilize or begin restoring their financial positions.

Senator EXON. Mr. Chairman, I urge you to take a closer look than you have, because what you have just said, I think, is the prevailing view. It is not just the 25- to 35-year-old farmers who are in deep trouble today. If you will have your people take a look at land values, you will see how serious it is.

If somebody lives in a $100,000 house in town and that value drops to $75,000, so what? They keep making their payments and they live there. Their financial statement is reduced by $25,000 but so what?

Not so in agriculture. For many years, we have been living on escalated values of land. They got up too high. There is not any question about that. But now the rude awakening is coming home, and some of the information that I am getting from my agricultural circles today and the top bankers and financial people out there in the great farm belt of America could spell some more serious disaster for our local economy than I think you generally realize, and I encourage you to take a look at that.

Mr. VOLCKER. Let me just add to that. I think there is no question that land prices have certainly leveled off—and people counted on increases in the past—and not only leveled off, but in many areas declined.

Senator EXON. They are level. Leveling off is the wrong term. But you better take a look at it because I think it is something that might affect your policies.

Mr. VOLCKER. I think generally they have declined.

Senator EXON. Dramatically, not just declined. They have declined dramatically.

Mr. VOLCKER. That depends upon the area, I think.

Senator EXON. They have declined very much in the area that I represent, and that is very important to me, and I think that if it has declined in my area, they probably have declined much further than you anticipate in your decisionmaking process.

TRY TO ACHIEVE DEFICIT REDUCTION ON SPENDING SIDE ONLY

Now, let me go on to some other things that are of major concern to work our way out of the difficulties that we are in. It seems to me that you have given us good advice over the years. We have just got to cut spending. I do not think there is any question about that. We have got to cut spending further.

I believe that if we can bite the bullet the way we have to bite it that we might be able to reduce spending in all areas enough so that a tax increase would not be necessary. But that presumes, it seems to me, that the deficit, under the CBO estimates, would continue to dramatically increase to $248 billion in the outyears of 1989, and it seems to me that you are telling us and other respected economists are telling us that if we allow that to continue we are likely to abort the economic recovery that is now selectively, and I underline the word "selectively," taking place in the economy.

In your opinion, if we did not do anything with taxes, if we could just restrain spending enough so that those deficits projected by 1989 upward by the Congressional Budget Office, if they were maintained, we would run a high risk of serious economic difficulties, would we not?

Mr. VOLCKER. If you cut expenditures, but the deficit ended up in the $250 billion range?

Senator EXON. Right.

Mr. VOLCKER. Yes, that is too high. You want to aim at a lower deficit than that, a significantly lower deficit than that.

But let me say if you could achieve the deficit-reduction target entirely on the spending side, more power to you. From a strictly economic standpoint, from the standpoint of the efficiency of the economy, that seems to me clearly the best way to do it.

But there are other considerations that obviously enter in, noneconomic considerations. You have a defense program. You have social programs. All I have said is ideally you should do all of it on the expenditure side, or certainly do as much as you can on the expenditure side, but if you cannot do it all on that side, as a practical matter, you have to look at the revenue side, too.

Senator EXON. Excellent advice. I agree with you 100 percent, Mr. Chairman. Let me ask you a followup question. Do you think it is at all practical or possible, given your knowledge of the system, that we can reduce those deficits without some significant enhancement of revenue?

Mr. VOLCKER. You are asking me, I suppose, for a political judgment now?

Senator EXON. No. I am asking you for a judgment that we have to make, and I do not consider our judgments here political. We apply them in the best interest of the Nation.

Mr. VOLCKER. I do not want to draw a contrast between a political judgment and the best interests of the Nation. I mean what is doable as a practical matter.

Economically, I would prefer to see you do it all on the spending side, as I said. As I observe the debate, it seems to me you are going to have to end up doing some of it on the revenue side. But do as much as you can on the spending side.

STRUCTURAL REFORM OF TAX SYSTEM SUGGESTED

Senator EXON. I agree 100 percent. Now, one last question. The administration has a secret plan that they keep talking about for coming forth with some tax increases after the November elections, if they are still around.

Chairman DOMENICI. Where did you hear about the secret plan? I am not being facetious, but I am unaware of it.

Senator EXON. Well, it was outlined. I was there, Mr. Chairman, when the President gave his state of the Union address. At that time, he indicated that he wanted the Treasury Secretary to come up with a plan to restructure the tax system.

Has the administration revealed in any way to you by specifics or hints what kind of a tax plan they have in mind, after the election, and could it possibly be of value-added tax; and if so, what is your recommendation on that proposal?

Mr. VOLCKER. My impression, and it is a very general and vague impression, is that they will be reviewing several possibilities in constructing what might be called a broader based tax. I think some version of a value-added tax might come under that general framework, but a reform of the income tax structure would also be a clear alternative to that. They may be looking at other things.

They have promised or suggested a structural reform of the tax system, and I presume they would be looking at a variety of possibilities. I do not have any sense that any one action is firmly in mind, but they do have a sense that a value-added tax is worth looking at; I would agree with that.

My own sense is that if you cannot get the expenditures significantly lower in terms of, let us say, a percentage of GNP, you are going to have to look at some changes in the tax system to make it more tolerable in terms of economic efficiency and probably in terms of considerations of fairness and simple observance of tax rules; you are going to have to make some structural changes in the way we collect taxes and consistent with the level of revenues that we are going to need to support the higher level of spending.

Senator EXON. And politically salable.

Mr. VOLCKER. And politically salable in the end, using the word "politically" in a broad sense.

Chairman DOMENICI. He means good sense.

Senator EXON. We have both emphasized that. Thank you very much, Mr. Chairman.

SAVINGS IN DEFENSE OUTLAYS

Chairman DOMENICI. Senator Johnston, I wonder if before you ask a question you would engage in a conversation with me. Whoever wants to listen, may. Let me just share something with you because I hear people talking about getting this deficit down.

We are going to reduce outlays. If need be, we are going to put some taxes on. Let me give you a little of what I figured out up to this point. First, you take defense and save $80 billion off the President's budget authority over 3 years.

Senator JOHNSTON. What is that? About 4½, 5 percent?

Chairman DOMENICI. That is 4½ to 5 percent average real growth for 3 years. You will save about $45 billion in outlays over 3 years, and I regret to tell you even at that it is tail end loaded. There is about $9 or $10 billion savings in the first year and it gets bigger in the third year. If you found a way to say this is what we are going to do and you all reauthorize in the committee so it is stuck at that level, those are the savings you get.

Now, I am not aware of very many people that are really concerned about defense. You are one. Senator Exon is one. Not too many think we can do an awful lot more than that. There are some people saying we do not need any real growth in defense.

Those who have looked at it say this sounds like where we ought to be going if we do not want to sacrifice how far we have come.

DO NOT TAMPER WITH SOCIAL SECURITY

Put that one down. That is $45 billion. Now if you go over the rest of this budget, you make one decision that you are going to take social security off the table. I do not know if you should take social security off, but I want to tell you those people meeting with the President's people decided right upfront—I was not there—that we ought not tamper with social security.

Senator JOHNSTON. Take it off you are saying.

Chairman DOMENICI. Take it off. It is not on the table for this year. Set it over here. We just reformed it so leave it alone. I want to tell you that was a decision made by Democrats and Republicans. That was Jim Wright and the people from the House, and I would submit to you that unless one wants to make some noise, then clearly, unless there is bipartisan and Presidential support to do anything different, we are not going to do anything different than that. I think you just leave that there.

FREEZE DISCRETIONARY APPROPRIATIONS

Now, if you do that, and look at the rest of the budget, if you want to freeze discretionary appropriations, for a year, and you are on that committee, and you are very interested in some of the appropriation accounts including agriculture, you are going to save over 3 years $13 billion. Freeze it and then go 5 percent, 5 percent. You are going to pick up $4 billion savings in 1985. That's $4 billion in outlay savings.

And if you then look at the reconciliation bill which froze COLA's through January and designed savings from military retirement and the others, you get about $13 billion to $15 billion over 3 years.

Then you take medicare and you do a dramatic thing, the B reform that is in the Finance Committee, and you get $12 billion savings. Now, my arithmetic tells me that at that point we are at about roughly $40 to $40 billion if you just want to look at three things. Forty billion dollars in outlays for defense, $40 billion on the rest of the budget, and I would ask are we really going to do more than that in the rest of the budget? I do not think so.

I do not think you are going to do more than freeze discretionary appropriations. You are really an active person on that committee. You have been on it for years. You chair a very important subcommittee. You offer a critique of what I am saying.

I think that to do what I have just described is pretty tough medicine at this point in time. Now, you add that up and you are at about $80 billion in outlay savings for 3 years, and there is only one thing left, and that is taxes.

TIMING OF TAX INCREASE IMPORTANT

Now, I submit that all the talk about reducing the deficit a lot more is going to be in the tax area, and I am not going to ask this chairman what he thinks about this, but basically, the President has recommended $44 billion in revenue increase in his butget proposal to us. That is gross, Senator, because he also had some new tax proposals which lost revenue, so the net total came down to $33 billion.

But basically he, by coincidence, has $44 billion in new revenue. Now, it seemed to me when we started talking about this that we already had some symmetry, 40, 40 and 40, more or less.

Now, I submit that for those who say let us do more, the only place you are really talking about doing more is taxes. I submit that unless you are seriously, philosophically concerned about indexing and you want to get that off the table right now, because it is going to vest shortly, you haven't much time to be courageous about taxes because that takes effect very soon. It is not one of these items where we have any lead time.

If you need $150 billion, you can pass a tax bill in January, February, March, or April. Clearly, a tax bill has the most economic impact of all the three. If you do that one wrong, you can have an impact on the recovery.

I mean, there are some who say put a big corporate tax on. We ought to really think about that in terms of the corporate vitality that is leading to the recovery.

So it seems to me the whole discussion is about when you put taxes on, not how much you reduce the deficit, and I would think that Chairman Volcker has given us a notion that you ought to get as much as you can in 1985 and early 1986. Clearly the most responsive one to that suggestion, and the one you can probably do, if you want to do it, is taxes.

So I do not understand why there is all this "we better do $250 or $300 billion now," unless somebody knows something I do not know or unless they are not serious.

COST OF LIVING MINUS TWO FOR SOCIAL SECURITY

Now, granted if you want to put social security back on the table, you've got a different ball game. But I want to give you another number. We used to think if you control COLA's in social security and other programs we were really going to take that deficit apart. Well, if you take cost of living minus two for social security for a year, because we got that inflation down so much, Senator, I will give you the number. That is $4.2 billion. That is what you will get, cost of living minus two for the big program which you just changed, moving the COLA over to January. It used to be you would get $12 billion, $14 billion. Now, with lower inflation, you get $4 billion.

Over 3 years you save $10 billion or $12 billion, $13 billion.

Senator **JOHNSTON**. If you do it once, you get the $4 billion every year.

ONE-FOR-ONE SAVINGS ON TAXES

Chairman **DOMENICI**. That is correct, off the base. So I mean, since you were asking me about defense a little while ago, I wanted to take time (and I apologize for doing it off your time) to just share some suggestions with you all. It does seem to me it will boil down to that one item, and I wonder if that is not one that you clearly ought to go with. You can get broad support on that and then take a look, because you will get one-for-one savings on taxes.

It is not like budget authority in defense where you take $80 billion savings and get $20 billion. Whatever tax you want to put on, you are probably going to get deficit savings by that amount. It is pretty easily definable.

Senator **EXON**. Mr. Chairman, if I could just make a brief comment.

Chairman **DOMENICI**. Sure.

Senator **Exon**. Thank you. What you have just said is what I am hopeful we can come up—something along these lines. It sounds to me like what you have just suggested is not significantly different from the so-called Johnston-Exon-Nunn-Boren proposal that got only 13 votes on the floor of the U.S. Senate last year. There has been a significant change.

Also, would you not say that what you just said—you are agreeing with me that maybe doing the things that you have just outlined, or some combination of those with some others, may lead us to not have the deficits soar in the outyears above what CBO projected, up to 248 by 1989.

But if we are really significantly going to do anything about that, we are not simply going to be able to do it with even more spending cuts that you just outlined. Is that a general——

Chairman **Domenici**. I think that is right. And, Senator, I do not know if it consistent with Exon-Boren; if it is, that is fine. I did not describe it in terms of having read it somewhere. It just happens to be the facts as they come out when you start looking at them.

Senator **Exon**. Thank you.

TIME TO CUT SPENDING AND RAISE TAXES IS NOW

Senator **Johnston**. Well, Mr. Chairman, if I may respond to that, I would very much agree, save in one instance, and that is that I have been here when we have tried to cut the budget when the economy starts on the downslide. And when it starts on the downslide, Chairman Volcker and everyone else will be here to say you cannot raise taxes; you can't cut the deficit; it will make the recession that much more difficult.

The time to do the cutting and the tax-raising is now while we are on the upswing. Am I correct in that, Mr. Chairman?

Mr. **Volcker**. I would think there is something to what you say, yes.

Senator **Johnston**. And the timing is now. I fear if we wait until next year to do these things like revenue raising—and by the way, I would not want a revenue raise, period; I would want it balanced with other cuts, such as in defense, as you described. But now is the time to act, and I will certainly join with you in that effort.

PUT GOOD FACE ON ECONOMY FOR ELECTION TIME

Mr. Chairman, you are not only an eminent, but a great economic and political historian. Now, if I may call on that fund of historical and economic background, over the last 35 years in an election year, it seems to me that history will bear out that administrations have gotten the cooperation, shall we say, of the Federal Reserve System, in the past now, on monetary policy that accommodates putting a good face on things for election season.

Am I correct historically on that?

Mr. **Volcker**. I cannot find the record clear on that subject, no.

Senator **Johnston**. That has occurred in the past, has it not?

Mr. **Volcker**. It is a common presumption of many people, I find. I think the evidence is much less clear than the presumption.

Senator **Johnston**. The presumption continues to live and to thrive, I can tell you.

Mr. **Volcker**. I am as conscious of that as you, perhaps. It is part of our folklore, but the folklore is not always right.

Senator **Johnston**. All right. Now, Mr. Chairman, if you were called upon to put a good face on the economy for election time, and if you were in a mood to do so—and, frankly, I do not believe you would be and I am not asking you that question, at least not at this time—how would you do it?

What would you be asked to do and what could you do and what would be the result? We are talking about a temporary good face.

Mr. **Volcker**. I do not know; maybe that is the best answer to the question. It presumes that we have some magic tools with which we can manipulate everything in the course of 3 months, 6 months, 9 months, whatever time period you have in mind; that somehow we can make everything come out right during that period of time.

I wish we had those kinds of tools. We would presumably exercise them all the time, and we would never have any problem. We are under the most intense kind of public scrutiny, as you know, with every wiggle in the figures or wiggle in interest rates, or whatever.

It is a little hard to do something that is not visible, but you ask what would you do; I do not know.

REDUCE REDISCOUNT RATE

Senator **Johnston**. Well, how about reducing the rediscount rate to 30 days?

Mr. **Volcker**. This is the presumption that you do something to ease money in some sense. If we eased money in the sense of increasing the money supply excessively, I am not at all sure that would have a healthy effect on the economy.

Senator **Johnston**. I am not talking about long term; I am talking about short term.

Mr. **Volcker**. You know, whatever we do probably does not have an effect without some lag, so what can you do in the short term? You can dress up, or you could attempt to dress up a market for the space of a month or two. Maybe it works, maybe it does not work, but if it backfires on you in 6 months, you have not done much. I think there is a great risk of it backfiring.

Senator **Johnston**. You have done a lot to change the course of politics in the country. And, again, I am not saying you could do that. Really, what I am getting at is what picture can you give to people out there who are looking cynically at the Federal Reserve Board and saying, look, you do not have to worry about interest rates between now and November; the Federal Reserve Board will manage those rates so that they will not squirt up. But get out of at least the bond market before November because——

Mr. **Volcker**. I hear about those comments. The question is not exactly new to me and I have been scratching my head about what kind of answer to give. I can say and say again that we are going to conduct policy as best we can in the continuing interests of the United States.

That is our designated responsibility by the Congress. That is what we are going to do. But how can I prove that?

MARKET REACTION TO REDISCOUNT RATE REDUCTION

Senator **JOHNSTON**. Well, just tell me how you would dress up markets for a month or two, if you wanted to do that, and I know you do not.

Mr. **VOLCKER**. I do not know of any tool we have other than deliberately increasing the money supply. It has a lot of fluctuations of its own, but you would set out to deliberately do that. You might reduce the discount rate, I suppose, and try to get interest rates down. Now, what the response of the market would be to that is another matter.

Senator **JOHNSTON**. Well, over the short term would not a rediscount rate reduction give you an immediate reduction in short-term interest rates?

Mr. **VOLCKER**. Let us say we did that right now, when the economy is expanding faster than people anticipated and the most recent data for some, but not all, of the measures of the money supply are not particularly low, and not running through the roof either.

I think if we set out to do that today, against the economic background that exists today, the action might be incomprehensible to a lot of people, and I do not know what the market reaction would be. It might be a very confusing market reaction.

If it was interpreted as the Federal Reserve going political, let us say, and given the situation that exists today with clear and evident inflationary implications, I think the market reaction could well be adverse. Even in the short run, it might be adverse.

FEDERAL RESERVE BOARD WILL NOT BE POLITICAL

Senator **JOHNSTON**. Let me ask one final question. Can you assure the American public and the markets that the Federal Reserve Board and its Chairman will not in any sense be political in this election year?

Mr. **VOLCKER**. Yes, I will give you that assurance, to the best of our ability.

Senator **JOHNSTON**. Thank you.

Chairman **DOMENICI**. We got mixed up and just had you starting.

Senator **JOHNSTON**. Well, I did have another round of questions here.

Mr. **VOLCKER**. I suspect I might add that whatever we do this year will be interpreted politically. That seems to be endemic and it is a source of concern, but I do not know what to do about it.

Chairman **DOMENICI**. Senator Sasser.

Senator **SASSER**. Thank you, Mr. Chairman. In defense of Chairman Volcker, I wish to say that there are many who felt that in 1980, we did not go through the process of dressing up the economy for the elections in that year. And I think you might be able to call down to Georgia and get affirmation of that, Mr. Chairman.

Chairman **DOMENICI**. Are you speaking to me or to him?

Senator **SASSER**. Well, either one. [Laughter.]

Chairman **DOMENICI**. Do you want to call down there and see?

Mr. **VOLCKER**. I think, if I might just comment on that situation, it is a perfect illustration of what we have been talking about. I read firm accusations that we took actions in that period of 1980 for political purposes, but these accusations come from both directions; that we were either trying to help the administration or hurt the administration. I take confidence in the fact the accusations come with equal force from both sides.

STALEMATE DOES NOT PRESENT POSSIBLE NEW RECESSION

Senator SASSER. Mr. Volcker, let me just ask you this question. There is a lot of talk about the so-called bipartisan budget panel's negotiations to reduce the deficit, and the problem seems to be that the President is simply intransient on the discussion of two very key elements of the deficit reduction package, and clearly that is defense spending cuts and revenue increases.

Now, some of us, including the distinguished ranking member of this committee, are calling for at least a $200 billion deficit reduction over the next 3 years. Now, the administration is saying that $100 billion is going to be enough, and I am glad to see that you have indicated that $100 bill will not be enough.

As matter of fact, that ought to be called the drop-in-the-bucket solution, the 100 billion solution. One of our distinguished colleagues, Russell Long, characterized it as that just the other day.

But the White House has now rejected the plan for tax increases and defense cuts that were put forth yesterday or the day before yesterday by the National Governors Association. And our chairman of this committee went over there and offered to hold defense spending at 5 percent real growth, which I thought was a very constructive suggestion, but he was not received very kindly when that was offered.

Now, given the apparent stalemate here that the White House is not going to go along with any cuts in defense spending and that they are not going to go along with any revenue increases, it appears to me that there is not going to be any meaningful action in dealing with this deficit if both of those alternatives are foreclosed upon.

And my question to you is, given the apparent stalemate and barring any significant action this year, are we not facing the distinct possibility of a new recession in the not too distant future, and I am talking about the end of this year or certainly sometime next year, and if not, why not?

ECONOMIC OUTLOOK WITHOUT DEFICIT REDUCTION

Mr. VOLCKER. I do not want to share all your assumptions about stalemates. You are asking me what happens if nothing is done about the deficit.

Senator SASSER. Yes sir, in essence, that is what I am asking you because I am not sanguine, Mr. Chairman, that anything significant is going to be done about it this year. I think that is a tragedy and I would like to get your views as to what is going to happen if nothing is done.

Mr. VOLCKER. I can only repeat the answer I gave earlier. I think the economy currently has a lot of momentum; it is expanding rather rapidly. Our own best estimates, collectively, in the Open Market Committee have been for a quite satisfactory economic advance during the rest of this year.

But at the same time, I think you are taking more and more risks, which mount over time, of the nature that I have tried to amplify earlier in my comments. I think the good news is that you get a continuing economic advance—if you do—that is lopsided; it is not healthy in terms of long-term productivity, long-term growth. It is distorting in some important areas of the economy; it carries the seeds of disturbances in some areas of the economy, and I am thinking particularly about the international side. It increases financial risks.

Do I think that is likely to end up in a recession this year? No; our forecast is otherwise, and I would think it could continue, but it is not a satisfactory kind of recovery. I think the risks multiply, the dangers in several directions—and I do not think they can all be summed up in the word recession—increase.

We get the risk of violent exchange rate movements, inflationary developments, financial pressures that lead to unsettlement and further undermine the prospects for investment. There are a lot of things that can go on in the economy that are not very healthy and the risks of those things, I think, multiply as time passes.

But right now, the economy, skewed toward consumption, has got a lot of momentum.

Senator **Sasser**. There has been some—and I know my time is up; let me ask just one more question, Mr. Chairman.

Chairman **Domenici**. Sure.

FEAR OF INFLATIONARY PERIOD

Senator **Sasser**. Chairman Volcker, I think you have indicated that you have some fear that we may be getting into another inflationary period, and there has been some discussion that because of the fear of inflation, the Federal Reserve Board will tighten up once again on the money supply.

Now, the Consumer Price Index last year was extraordinarily low by modern standards. Union wage settlements last year were even below the rate of inflation. We are starting to see that productivity gains are beginning, and most inflation projections are fairly moderate.

Why are you concerned at this juncture about a surge in inflation, and why would the Fed be talking about tightening up the money supply?

Mr. **Volcker**. I do not think we are talking about tightening up the money supply. We have given you the targets for the money supply and I tend to be fairly optimistic on the inflationary side.

You have recited all the reasons why I think we have an enormously favorable opportunity here to get this economy moving in the way we would like to see it—with more stable and sustained growth at the same time, and I think those things have to go together.

Senator **Sasser**. Yes, sir, and I agree with you.

Mr. **Volcker**. And we have made a lot of——

GET BUDGET DEFICIT UNDER CONTROL

Senator **Sasser**. What we have got to do now is get this budget deficit under control. And as Senator Johnston said, if we are going to go for raising additional revenues, it is going to have to come this year.

Excuse me; I interrupted you.

Mr. **Volcker**. You basically have made my point. We have made a great deal of progress and you have recited the key points of evidence, and I think we have a great chance of sustaining that progress.

The big cloud looming over all of this is the budgetary deficit. I do not minimize the difficulty of reaching a consensus, but still the good news is it is something that is under our control. It is not imposed on us by OPEC or natural disasters or something going on abroad or something inherent in the structure of the economy.

The problem is right here and we can deal with it. The question at issue is whether we will, and those favorable factors that you cite are precisely the ones I do not want to see upset by this problem that is within our own capacity to handle.

Senator **Sasser**. Thank you, Mr. Chairman.

Chairman **Domenici**. I assume you want to go another round, Senator Exon.

Senator **Exon**. Yes. I have two or three questions, Mr. Chairman.

FIRST QUARTER GROWTH PREDICTED AT 6 PERCENT

Chairman **Domenici**. Let me just ask a couple and then I certainly will yield as much time as you want; I do not think anybody else is going to come.

Mr. Chairman, let me ask you this. I just heard from my staff that the announcement today of the leading economic indicators, along with other recent indicators, would probably predict the first quarter growth at 6 percent, or close to it.

Mr. **Volcker**. The current quarter?

Chairman **Domenici**. Yes, first quarter. I think there is an opposite question to the one Senator Sasser asked; I ask it only for the record. It was asked whether you would do anything to put the best coating on a bad situation.

I would ask do you intend to do anything that will negate the kind of growth that is occurring.

Mr. **Volcker**. I do not know precisely what kind of growth is occurring.

Chairman **Domenici**. Well, whatever it is, it has been good. You have been heard to say it might be better than you thought; it might be higher than is needed. I am just asking that question.

Mr. **Volcker**. In general terms—and I do not want to be precise about this—we certainly want to see the economy growing within the limits of the tools we have.

Chairman **Domenici**. Correct.

Mr. **Volcker**. Our general expectations, and certainly a figure that would be satisfactory from our standpoint—but I do not want to say we would limit growth in some artificial sense—is in the range that we and others have projected, 4 to 5 percent for the year as a whole.

In reaching that judgment, you have got to look at what else is going on. To take the primary other dimension, what are the inflationary forces doing? Are there rising dangers on that side or do they remain well under control?

That is the kind of judgment that enters into some particular policy judgment at some particular time. Recognizing all the hazards there are in projecting growth even a few months ahead, we just cannot look at what is going on in real growth, but must also try to reach a balanced judgment as to its sustainability.

That is really what you are interested in. How can we keep this expansion going? That is much more important than whether growth is 6 percent one quarter or whether it is 3½, 4, 5, or 5½ percent this year.

Are we laying a foundation for continuing, decent growth in 1985, 1986, 1987 and beyond? I think that is really the task that we face in monetary policy all the time. In a sense, it is the task you are facing in budgetary policy right now. The inflationary side of that equation—the inflationary prerequisite, I might say—seems to me to be encouraging, not only continuing containment of inflation, but also over time—I am not saying every year—implying further progress toward stability.

Are we staying on course there as well as on the growth course? We make the best judgments we can make about how we can contribute, by monetary policy, by changes in the money supply, to that end.

NO TIGHTENING OF MONETARY POLICY

Chairman **Domenici**. Let me be very basic and frank about it. I guess what I am asking is do you envision tightening the money policy in order to thwart growth in the next 10, 12, 14 months?

Mr. **Volcker**. We do not envisage tightening monetary policy—I do not know what you mean by thwarting growth—for that purpose. If the economy is growing at 6 or 7 percent, it cannot grow at 6 or 7 percent for very long, in my judgment. I am talking now not over a quarter or two quarters or three quarters. At some point, you run out of capacity. You run into pressures on the economy that would doom the sustainability of the expansion. We would like to see the expansion proceed at a sustainable rate. I do not think it is in our interests to see it proceed at a maximum rate over the space of two or three quarters if the implication of that is it is only going to last for two or three quarters.

Chairman **Domenici**. As you know, Chairman Volcker, there are some people, including some Members of Congress, and some whose approach notions of economic prosperity in America are not as traditional as yours. And there has been an insinuation, if not an accusation, that you are tightening money, and thus are going to abort the so-called recovery, and you have explained that to us now.

Mr. **Volcker**. We want to see as much growth as we can, consistent with sustaining that growth. I think that is the best way I can put the approach.

SIGNIFICANT ACTION ON REDUCING DEFICIT POSSIBLE

Chairman **Domenici**. Now, Mr. Chairman, my last question, and if you do not want to answer this, that is all right with me. I really regret that you have been put in a position of trying to put dollar dimensions to an adequate fiscal response by a Congress in an election year.

Some have assumed you have said unless it is $50 billion in savings in the first year, it is not an adequate plan, and you have already told us you have not said that. So you have heard what I have just discussed with Senators Johnston and Exon about a possibility, something that might be doable, a 40-40-40 real—or 45-45-45, plus or minus 2 or 3 percent; I am not holding anyone to it.

I am asking if you would comment in some way that would be of help to us. Would that be a significant action, all things considered?

Mr. **Volcker**. There is no question of that. In my judgment, that would be a significant action and it would be a marked improvement from where we stand now.

Chairman **Domenici**. And using your language, it would minimize the risks that you have been telling us about?

Mr. **Volcker**. It would move importantly in that direction. I do not think it ends the budgetary problem; you are perfectly aware of that. I would like to see you do as much as you can do as early as you can do it. And you are quite right; I do not want to be pinned down to any particular number.

The history of that $50 billion figure is that it is a round number; I gave it originally in response to a question as to what would make a clear and noticeable impact on the market.

I do not think there is any question that a program of the size you are proposing would be a substantial step forward.

Chairman **Domenici**. Senator Exon.

STANDBY TAX INCREASE

Senator **Exon**. Mr. Chairman, thank you. I will be brief. You have been very patient, Mr. Volcker, and we appreciate it very much.

Just a comment about these buzz words. Downpayment—I do not quite understand how we invent these phrases in Washington, D.C. My determination of a downpayment has always been that an individual or a company or a corporation or government is about to assume and launch on a new, expanded debt assumption plan.

But we have turned this downpayment buzz word around into something that I think is extremely dangerous unless the people understand what we are or are not doing.

In the 1984 budget that the President sent over here, he had about a $50 billion standby tax increase that was going to take place in 1985, in the event it was needed. That has disappeared from the President's budget that he sent over here.

Was there ever any explanation to you by administration officials as to why they felt a tax increase in 1985 was necessary last year, but not necessary this year?

Mr. **Volcker**. I have heard, certainly, that one consideration was that it was not very warmly received last year.

Senator **Exon**. It was not very warmly received where?

Mr. **Volcker**. By the Congress or the public. I am not saying that is the only reason. I think there was a certain reluctance in putting it forward in the first place, but I think there is some evidence that people did not stand up and salute very rapidly in response to that proposal.

PRESIDENT'S ECONOMIC ASSUMPTIONS QUESTIONABLE

Senator EXON. One last question. The President sent over a budget here with certain economic assumptions that indicated that if we adopted his budget, per se—and I am going to phrase this to you in a question I think it might be easy for you to answer—if we were to accept the President's budget as it was sent to us, do you agree with the resultant economic conclusions predicted therein that between now and 1989, the T-bill rate would go from roughly 9 to 5, inflation would drop from 4.5 to less than 2, and unemployment would go from 8 to less than 5? Do you think that is likely or possible?

Mr. VOLCKER. I am not so good at predicting the T-bill rate over the next 3 months, much less the next 5 years. But let me say I do not think those kinds of projections are by any means out of the ball park. Whether they are consistent with the budgetary picture, I guess, is the question you are asking.

And I would feel very strongly that those kinds of favorable projections would be greatly assisted in terms of their probability by much more forceful action on the budget than accompany the projections.

Senator EXON. Well, I am not trying to pin you down, Mr. Chairman, but my question related to the fact that if we bought the President's budget, per se, with the deficit that even he projected, do you think that the favorable economic assumptions that I just outlined—would it be possible for us to get to those figures if we took the President's budget from here on out?

Mr. VOLCKER. A lot of things are possible. It would not seem to me the most probable or most secure course, but I think you can make it. I do not think they are unreasonable as economic projections. What I am questioning is whether the budgetary part leads to those conclusions or reinforces those conclusions.

They show a continuing decline in the inflation rate. They show a decline in interest rates to a rather low level in so-called real terms. Whether you can achieve that combination of factors against the budgetary situation that was assumed does seem to me to be questionable.

Senator EXON. Thank you. Thank you, Mr. Chairman.

EARLY AND FORCEFUL START NEEDED

Chairman DOMENICI. I would say to you, Senator Exon, that I believe you are absolutely right. I do not think there is any chance that you are going to get those kind of numbers in the 1987–89 timeframe with a policy that says let us get $100 billion, and then we do not have any other way to get the rest.

So, obviously, we do not have a plug, but what we have is either a written narrative that we are going to have to do more to get to these numbers, or we just have them some way assuming a major change in deficit policy.

I hope we are not so far wrong in our oldtime, conventional thinking that you are not going to get down to 2 percent and 3 and 4, as you read them, with $250 billion deficits for 5 years. That is impossible, it seems to me. Added to what we have got, 70 to 80 percent of the available capital will be used just for financing the Government, and that is even with 4 or 5 percent real growth from what I can tell.

Mr. **VOLCKER**. I recall in those projections they got down to $125 billion, or something like that, by 1989.

Chairman **DOMENICI**. But they were sort of self-prophesying. They also predicted——

Mr. **VOLCKER**. To get the real run in that direction, you have got to have a more forceful attack and an early one. That is my basic point; that that kind of budget deficit is not out of reach at all, and those economic results are not out of reach. But the question is whether they are out of reach without an early and forceful start.

Senator **EXON**. In other words, could we phrase it another way and say that their projections of declining deficits are not fully realistic or honest under their budget?

Mr. **VOLCKER**. I think it takes a more forceful start; that is what I say.

Senator **EXON**. Thank you. I thought you would stick with that.

CREDIBLE BEGINNING OF REDUCING DEFICIT LACKING

Mr. **VOLCKER**. You know, things begin working with you, if I may just make this point, if you get the momentum going in the right direction. Right now, it is against you. As the CBO projections point out, nothing happens; interest rates stay where they are; they even show a little decline in interest rates.

Suppose they just stay where they are; things begin compounding and then you have this larger and larger budget problem every year and it looks impossible. I think it is impossible under those conditions.

But if you begin getting the deficit down, you begin having more assurance on the inflation side, people feel more confident in financial markets, and the direct pressures are taken off, and interest rates do begin coming down. Then the budgetary problem becomes easier and you end up with smaller deficits. But you have got to begin the process.

What is lacking, in my view, in those projections is a credible beginning of the process.

Senator **EXON**. Thank you.

Chairman **DOMENICI**. Thank you very much.

[Whereupon, at 11:58 a.m., the committee was adjourned.]

VIEWS OF OUTSIDE ECONOMISTS

WEDNESDAY, FEBRUARY 29, 1984

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 2:15 p.m., in room SD-608, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee), presiding.

Present: Senators Domenici, Gorton, Chiles, and Exon.

Staff present: Stephen Bell, staff director; and Gail Fosler, chief economist.

For the minority: Richard N. Brandon, staff director; and Garry Schinasi, senior economist for macroeconomics and fiscal policy.

Senator **CHILES**. The committee will come to order.

The chairman will be here momentarily. He is on the floor voting, and I got away just a few minutes before he did. Dr. Fischer, you may go ahead and start with your statement.

STATEMENT OF DR. STANLEY FISCHER, DEPARTMENT OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Dr. **FISCHER**. Thank you, Senator. I appreciate the opportunity to be here today.

There is rare agreement today on the need to reduce the budget deficit. But the general agreement does not extend to the details of when and how the deficits should be cut.

I will make the following points:

One, the current deficits are the highest in peacetime history and are not sustainable.

Two, real interest rates should be reduced to provide the incentive for continued rapid supply side growth. Such a reduction should be brought about by tightening fiscal policy.

Three, this is a good time to absorb the inflationary pressures that will result from the fall in the values of the dollar consequent on a reduction in the interest rate. A reduction in the rate is needed to begin to turn the trade account around.

LAST YEAR'S BUDGET HIGHEST IN PEACETIME HISTORY

Last year's budget deficit was 6.1 percent of GNP, the highest in peacetime U.S. history. The 1985 budget projects Federal deficits averaging 3.6 percent of GNP through 1989, which would leave the average budget deficit for the eighties at nearly 4 percent of GNP, well above the 2.7 percent during the Great Depression decade.

The administration's budget projections are based on the assumption that legislation will be enacted to reduce deficits sharply, to only 2.3 percent of GNP by 1989, that real GNP growth through the end of the decade will average more than 4 percent per year, and that the Treasury bill rate will be down to 5 percent by 1989. The Congressional Budget Office assumes an average growth rate for 1983–89 of 3.7 percent, more in line with recent historical experience, and a 1989 Treasury bill rate of nearly 8 percent, more in line with recent real interest rates a high deficit levels. On this basis, the CBO projects a current services budget deficit that by the end of the decade will be back at 6.1-percent of GNP and rising. But there is a significant difference between the 6.1 percent deficits for 1983 and 1989: less than half the 1983 deficit was structural, meaning that over half of last year's deficit was a result of the recession, whereas all the 1989 deficit would be structural.

The Treasury has sometimes claimed that rapid growth will bring deficits down to reasonable levels without further action to raise taxes or cut spending. An increase in the growth rate of GNP to an average of 4.7 percent for the years through 1989 would reduce the budget deficit to about 3.5 percent of GNP by the end of the period. A deficit of this magnitude is still well above historical peacetime levels, and is in any case extremely unlikely to be achieved without legislative action, because the required 4.7 percent growth rates of GNP are not conceivable—particularly with high real interest rates induced by the high deficits.

In my testimony today I will first review the likely consequences of a string of budget deficits of the magnitude predicted by the CBO, as summarized in Table 1, and then discuss the costs and benefits of taking action this year rather than next, or next year rather than in 1986.

TABLE 1.—CBO BASELINE BUDGET PROJECTIONS, 1983–89

	1983	1984	1985	1986	1987	1988	1989
Deficit (percent of GNP)	6.1	5.3	5.0	5.1	5.4	5.6	6.1

Note: Projections are for fiscal year current services budget (including 5 percent per annum real increase in defense spending), assuming average GNP growth rate of 3.6 percent for 1984–89, average inflation rate of 4.7 percent, and average Treasury bill rate of 8.2 percent.

SUSTAINABILITY OF SPENDING AND TAXING PLANS

The first issue is that of the sustainability of the spending and taxing plans that generate the deficits. Simply put, the question is whether the budget plans underlying table 1 will eventually create an enviable situation, in which taxes have to be raised, or spending cut, or the Fed monetizes the deficit in an attempt to keep the lid on interest rates.

The simple deficit, uncorrected for inflation and for the state of employment, is not an appropriate measure of the sustainability of a particular policy. But sustainability can be judged by the long-run effects of policies on the national debt. The CBO's projections suggest that the budget plans that generate table 1 cannot be sustained forever, because they would generate an ever-increasing

Federal debt relative to GNP. By 1989, the (privately held) debt to GNP ratio would be 50 percent, double the 1976 ratio.

Nonetheless, the economy could for a long time sustain a rising national debt, relative to GNP. At the end of World War II the debt was above 100 percent of GNP, and we would be far from that level even by 1989. Although the logic is inevitable that the interest bill generated by deficits of the magnitude in table 1 would keep rising, and the deficits would therefore keep rising relative to GNP, that is not the main reason to take action this year or next to reduce deficits.

MAIN REASON FOR REDUCING DEFICITS

The main reason to reduce deficits soon is that, with the economy continuing its vigorous recovery and approaching the full employment zone, it is desirable to reduce the stimulus of fiscal expansion, to reduce real interest rates and lay the groundwork for continuation of the expansion. I do not see an imminent danger that the large deficits will lead to sudden spectacular economic collapse.

The major possibility of sudden change is that investors might quickly lose confidence in the dollar and shift into foreign currencies, thereby causing cost pressures that would worsen domestic inflation. If the Fed felt compelled to tighten monetary policy to combat inflation, a recession could result. But it would be inappropriate for the Fed to tighten monetary policy at that point. Rather it should continue to pursue its monetary targets, intervening in the foreign exchange markets if necessary to smooth but not prevent the adjustment to a lower exchange rate.

The danger is less that of a sudden collapse than of a slowing of growth as high real interest rates keep investment low. The Fed shows no signs of increasing monetary growth to reduce interest rates, nor should it do so. Deficit reduction would reduce real interest rates, thereby both encouraging investment spending and long-term growth, and by reducing the strength of the dollar increasing net exports. Lower deficits will crowd in both investment and net exports.

The Treasury rightly argued in the last 2 years that the concern over crowding out was vastly exaggerated. So long as the economy was in a deep recession, as it was early last year, it would have been a mistake to raise taxes or cut Government spending. Such actions would have reduced aggregate demand, and slowed the recovery. With monetary policy for the most part following a careful restrictive path, fiscal policy was the chief engine of growth during the recovery. Further, the fiscal-monetary mix that produced high interest rates helped speed the disinflation by raising the exchange rate, thereby directly reducing the prices of imported goods, and indirectly reducing domestic wage and price inflation by exposing domestic industry to stiff foreign competition.

Given monetary policy, the expansionary fiscal policy of the last 2 years was desirable. Nonetheless, the monetary/fiscal policy mix had significant side effects in producing historically high real interest rates and reducing net exports. Real Treasury bill rates moved from a range of 1 to 2 percent in the period up to 1980 to the 4- to

5-percent range from 1981, and are not predicted to fall below that range through the end of the decade unless the budget deficit is reduced. After adjustment for inflation, the real value of the dollar has appreciated by over 30 percent relative to foreign currencies since 1980.

The view that large deficits raise interest rates has been disputed by both the Treasury and some academic economists. It is theoretically possible for the Treasury view to be right, but the conditions necessary for that are unrealistic. Econometric evidence on the issue is not totally decisive, but the weight of the evidence favors the view that the real interest rate rises when the full employment deficit rises. The most persuasive evidence for the view that deficits affect interest rates is that the current and prospective high deficits are accompanied by unprecedentedly high real interest rates.

The high real interest rates of the last few years did not significantly hold back the growth of investment during the recovery, except for investment in corporate structures and housing. Housing investment has been somewhat lower during this recovery than in earlier ones. But the January housing data suggest a strong recovery in housing continues. The strength of investment in this recovery despite the high interest rates is partly a result of the tax incentives given to firms in ERTA in 1981, as amended by TEFRA in 1982—as evidenced by the fact that plant and equipment investment has grown more rapidly than investment in corporate structures.

The strong dollar has moved net exports of goods and services from surplus in 1982 to deficit in 1983 and projected larger deficits through 1986, as the slow effects of cheaper imports and increased prices for our exports beging to take hold. The turnaround in net exports will amount to about $60 billion, or 1.5 percent of GNP, over the period 1982–86. With net U.S. ownership of foreign assets put at only about $150 billion, and net exports in deficit by nearly $50 billion already in 1985, it is easy to see that the United States will soon become a net foreign debtor.

REDUCING REAL INTEREST RATES

Reduction of the current budget deficit, or the deficits projected for future years, would reduce real interest rates. The interest rate would be reduced because aggregate demand for goods would fall. The lower interest rate would reduce the value of the dollar. As the interest rate and the dollar fall, the composition of private demand would shift from consumption toward investment, and from imported goods toward domestic output.

A restrictive fiscal policy that reduces aggregate demand lowers the inflation rate directly by reducing the pressure on domestic resources. This is to the good as the economy approaches full employment. But a falling dollar is on the contrary an inflationary influence: prices of imported goods rise, and the weakening of foreign competitive pressures results in higher prices of domestic goods. These inflationary pressures would manifest themselves for whatever reason the dollar fell, for example if foreigners lost confidence in the ability of the United States to get its budgetary situation under control. An increase in the inflation rate as the dollar weakens is the price that has to be faced for having successfully used the appreciation of the dollar in stabilizing prices in the last 2 years. It would be better to have the cost increases from dollar depreciation work through the system after fiscal policy has been tightened and before the economy is at full employment than to wait for a possible rapid capital outflow and dollar depreciation if investors were suddenly to lose confidence in the dollar.

QUESTIONS CONFRONTING THE COMMITTEE

The major questions confronting this committee and other economic policymakers are whether the deficits should be reduced sooner rather than later, what combination of tax increases and spending cuts should be introduced, and what level of deficit to aim for.

The most important requirement at present is to provide assurance now that the deficit problem will be seriously confronted within the next 2 years. Without such assurance, stock and bond market investors have little basis for believing that interest rates will come down in the foreseeable future, and they will therefore not come down now. Investment will continue to be crowded out, and capital formation will not make the supply side contribution to economic growth that it should.

This year's projected deficit would not have major adverse consequences if investors could be reasonably certain that the budget problem would be on its way to a solution within the first year of the next Congress. Indeed, until the beginning of this year, it was probably widely taken for granted that there would be a major tax package immediately after the election, combining reform with tax increases to help balance the budget. The depth of the controversy over the deficit within the administration must have raised doubts about its willingness, if reelected, to go along with deficit reduction measures that would raise taxes rather than cut spending. This left open the prospect that there would not be major deficit cuts after the election. This uncertainty contributed to the stock market decline in January, which will have an adverse effect on investments.

The question of the best way to provide assurance that the deficit problem will be attacked in the near future is important but not one on which I can offer any expertise. The very real efforts being made in this committee and elsewhere in the Congress to formulate deficit-reduction plans are clear evidence of the seriousness with which the issue is being treated now and a strong signal that the problem will continue to receive attention next year.

The economy would benefit if some measures—if necessary to take effect only next year—could be put in place this year. Taking action this year is preferable not because this year's deficit in itself poses a substantial threat to the recovery, but rather because taking action this year would be persuasive evidence that economic policy is not paralyzed by the controversy over whether taxes should be raised or Government spending out. The balance between tax increases and spending cuts has of course to be struck in the the political process.

A target for the 1987 deficit of 3 percent of GNP, a cut of 2.4 percent from the 5.4 percent for 1987 in table 1, looks sensible. A deficit equal to 3 percent of GNP would be consistent with a debt to GNP ratio of about 40 percent, approximately the level the debt will have reached by 1987. A deficit of about 3 percent of GNP would thus stop the increase in the ratio of debt to GNP. Any futher reductions in the deficit in future would help increase the rate of investment. Whether such reductions should be aimed for depends on the state of the economy 3 years from now.

The present concern over the size of deficits is fully justified. But I would nonetheless like to end with a reminder that the deficit we should be looking at is the full employment or structural deficit. Running budget deficits during recessions, as during the recent recession, is good fiscal policy. But as everyone knows and agrees in principle, it is bad policy to run unsustainably large full employment or structural deficits. The need is to translate agreement on principles into a practical agreement.

Chairman Domenici. Thank you very much, Dr. Fischer. Richard N. Cooper is at Harvard. We are delighted to have you. We have your prepared remarks. They will be made a part of the record.[1] You may summarize them or proceed to give them as prepared.

STATEMENT OF DR. RICHARD N. COOPER, BOAS PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

Dr. Cooper. Thank you, Mr. Chairman. I appreciate the opportunity to come before the committee.

My assignment is to address the external consequences of the budget deficit. What I propose to do is say something first about the external side and then turn to its relationship to the budget deficit.

NO TIME IN LAST 15 YEARS HAS DOLLAR BEEN STRONGER

On a U.S. trade-weighted basis, the U.S. dollar is stronger now than it has been at any time in the last 15 years. In particular, it is stronger than it was before the Smithsonian agreement which first devalued the dollar in December 1971. Some estimates place the dollar as being overvalued by more than 25 percent. I do not want to get into a debate on the essentially semantic question of whether a currency can be overvalued in a period of flexible exchange rates. But the dollar is unquestionably stronger than it has been for over a decade, and that has important consequences for our trade position and for the U.S. economy, with which we must be concerned.

The principal observable result is a huge merchandise trade deficit, running at annual rates of nearly $80 billion in the last quarter of 1983. After allowance is made for our net earnings on overseas investments and other services, the United States is now running a current account deficit on the order of $50 billion a year, and rising. To put this external deficit into overall perspective, the biggest current account surplus that the United States has run since 1950 was 1.1 percent of GNP; that was in 1964. Until last year, the largest current account deficit we have run was 0.7 percent of GNP; that was in 1978. That deficit was itself the source of considerable alarm around the world at that time.

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[1] See p. 595.

Data for 1983 are not all in yet, but the recorded current account deficit for 1983 will probably approximate 1.1 percent of GNP, the largest external deficit which we have had since we have kept records on the balance of payments. Put in other words, we apparently borrowed the equivalent of over 1 percent of our GNP from the rest of the world in 1983.

The huge trade deficit is due partly to the fact that the U.S. economy recovered more rapidly in 1983 than our major trading partners did, and to the fact that in a number of debt-ridden countries imports have turned down very sharply. Those are important markets for the United States. The worsening trade deficit represents the mechanism by which U.S. recovery gets transmitted to the rest of the world, and that is what foreigners are waiting for. It is the mechanism by which a buoyant U.S. economy gets diffused abroad.

But the worsening U.S. trade balance is also due partly to the very strong dollar. American firms find great difficulty competing both at home and abroad. The deficit may decline temporarily as recovery picks up in the rest of the world this year, but most of it will remain. As the United States borrows more and more from the rest of the world, our interest payments to foreigners will rise; and that by itself will tend to worsen the current account deficit even further.

LARGE EXTERNAL DEFICIT HAS TWO SERIOUS PROBLEMS

Apart from the anomaly of a capital-rich country such as the United States borrowing so heavily abroad, there are two serious problems with this large external deficit. The first is that American business firms and labor unions will confuse the consequences of a strong dollar with unfair trade practices abroad, and appeal for protection from imports. There are many foreign practices which are different from ours. That does not automatically make them unfair. They have often existed for a long time. In fact, we would ignore them if we could compete fully with the foreign products. But with such a strong dollar, attention is drawn to all kinds of practices which seem to give foreign products a special competitive advantage, and American firms will appeal under U.S. law for such protection as they can get, including under the provisions covering unfair trade practices.

It is perhaps worth noting here that under the Trade Act of 1974 escape clause action, or section 201 action, is possible so long as an American industry has been injured and imports are a substantial cause of the injury, regardless of what caused the imports. We used to have a provision that linked increased imports to trade liberalization, but that requirement was dropped in 1974. So we now have a setup under which a strong dollar can, over time, result in built-in protectionist response. Paradoxically, to the extent that it succeeds and certain imports are in fact restricted, the value of the dollar will simply be driven higher and will thereby worsen the competitive positions of our exports and of those import competing industries that have not received protection. In addition to these provisions under existing law, there will be calls for new congressional or executive branch action to restrict imports, calls that take on a special importance in an election year.

Yielding to these various calls for protection could abort the recovery by one of two channels. First, strong U.S. protectionist action might lead to retaliation or, less tendentiously, merely emulation in other countries—Europe especially comes to mind—leading to a general collapse of confidence in the world trading system such as occurred in 1930-31, following passage of the Hawley-Smoot Tariff. Second, substantial increases in protection in the United States might lead to large-scale default on external debts by developing countries who have been told that they must improve their trade positions as a condition for new loans to service and repay their outstanding debts. If they are unable to increase their exports because of protectionist actions here and elsewhere, countries in heavy external debt might simply cease servicing their debts, thereby throwing the international banking system into a crisis and undermining confidence in the international financial system. The worldwide uncertainties engendered by either of these sequences of events could lead to a sharp cutback in investment spending worldwide, which would abort the economic recovery.

There is a second very different difficulty with the external deficits of the size that we have been running. That is that they require foreigners to lend to us currently at the rate of about $50 billion a year, to cover our external deficit. Chairman Volcker says that it will grow to $80 billion during 1984, and Fred Bergsten suggests that it may even be as high as $100 billion.

Will foreigners be willing to lend this amount to the United States, especially as economic recovery, and hence demands on credit, increase abroad? My guess is that at some point—it is difficult to say exactly when—foreigners will decide not to lend on this scale to the United States at current interest rates. That would not imply any basic loss of confidence in the U.S. economy, but rather recognition that the current situation cannot be sustained. At that point, U.S. interest rates will have to rise, or the dollar will fall, or both. While the dollar is falling, foreigners will hesitate to purchase U.S. securities. So, any drop in the dollar is likely to be sharp and substantial as soon as the preference of asset holders around the world switches away from dollars. At that point the United States will experience a rise in its price level. As Stan Fischer has said, that is the repayment, as it were, of the reduction in the price level that we enjoyed temporarily by having an appreciating dollar during the past several years. The Federal Reserve may then have to respond by tightening credit if market sentiment moves rapidly against the dollar, markets threaten to become disorderly, and generalized uncertainty spreads throughout the world economy.

REDUCE BUDGET DEFICITS FOR DOMESTIC REASONS

What can be done about this situation? Here I come to the relationship to the budget deficit. The current fashion, led publicly by CEA Chairman Feldstein, is to blame the budget deficit for our large external deficit and to urge a sharp reduction in that deficit as the way to reduce the strong value of the dollar. What might be called the Feldstein doctrine suggests that projected future budget deficits lead to high real long-term interest rates, and these in turn lead to a strong dollar relative to other currencies. The logic of this position is impeccable. But what about the magnitudes? Feldstein leaves the impression—I am not sure he has actually said it—that a substantial reduction in future budget deficits, the outyear budget deficits, will have a substantial effect on today's exchange rates for the dollar, and thereby will improve the competitiveness of both the import-competing and export sectors of the economy.

Secretary of Treasury Regan, in contrast, sometimes leaves the impression that budget deficits do not matter at all. I think he errs in dismissing Feldstein's concerns. But he is probably closer to being right on the magnitudes, at least at the moment, when the economy is still operating well below full utilization of its capacities. In my view, agreement today to reduce future budget deficits will, by itself, have only a negligible effect on today's exchange rates. I believe that Feldstein has identified correctly the causal relationship but he has exaggerated its magnitude. Agreeing on a reduction of future budget deficits will not, in my view, provide current relief from the strong dollar by itself.

I think that Secretary Regan, on his side, has exaggerated the role of political factors in inducing foreign capital to come to the United States. There is no doubt that much capital is fleeing from political or economic uncertainties abroad. But capital coming from Latin America cannot explain why the dollar continues to be strong with respect to the Japanese yen or the German mark. Moreover, it is difficult to explain the heavy British or Japanese investments that have taken place in the United States during the last several years by invocation of political and economic uncertainties in those countries.

I do not want my views to be misinterpreted. I do attach much importance to reducing the large projected budget deficits. I believe strongly that steps should be taken soon to reduce them. But I believe the need to reduce these budget deficits is largely for domestic reasons, the kinds of reasons Stan Fischer gave, rather than because of the relationship to the exchange rate and the external deficits.

ATTRACTIVE YIELDS ARE THE REASON FOR INFLOW OF FUNDS

Chairman DOMENICI. Dr. Cooper, may I interrupt and ask a question? Maybe this is begging the issue. It seems to me that the dollar is strong because interest rates are high. Maybe that is too simple an interpretation. It seems to me that that is why dollars are coming in, plus the political issues of asylum and we are the only safe harbor, and so forth. Do high interest rates have any bearing on why so much money is coming into America, and, plain and simple, are we paying an awfully high interest rate?

Dr. COOPER. I believe it does, yes. I believe that the most important explanation for the inflow of funds is not the political one, although that is a factor in some instances, but it is because yields have been attractive in the United States, yields on fixed-interest securities, the high interest rates, and yields on equity investments during the last couple of years, when the stock market has been rising so rapidly and profits have been rising rapidly. So, essentially for old-fashioned economic reasons foreigners are investing heavily in the United States.

Chairman **Domenici**. Money coming in is good, however, it is coming in because interest rates are high. If we conclude as a matter of the future of this economic base that we ought to get interest rates down, how do we reduce interest rates?

Dr. **Cooper**. Well, I am coming to that.

I draw a sharp distinction, overly sharp, for purposes of making the point, between short-term interest rates and long-term interest rates. I believe that the kind of argument that is in the Feldstein doctrine and which you have heard from Stan Fischer, linking future budget deficits to long-term interest rates, is very sound. I support it. I believe, however, that the influence of future budget deficits on current short-term rates, 3-month rates, 6-month rates, is negligible. And I believe that it is those short-term rates and not the long-term rates which are the principal reason, not the sole reason, by any means, but the principal factor attracting foreign funds. So, that raises to the question of why short-term interest rates are so high. But the logic I would put forward is that the outyear budget deficits are linked primarily to long-term interest rates, not to short-term interest rates. It is the short-term interest rates primarily that affect the exchange rate, although I admit there is some effect from long-term rates, too.

Chairman **Domenici**. I do not know that Mr. Volcker agrees. I think maybe he did not agree today. I do not know that we asked him with that much specificity, but I think generally he was saying that the interest rates of both combined are the result of very real marketplace forces that he says are generally related to fear of inflation, coupled with the fear of enormous deficits that are going to go unattended. So, I do not know that he disagrees.

How do we get the short-term interest rates down?

SHORT-TERM RATES INFLUENCE LONG-TERM RATES

Dr. **Cooper**. That is the point I am coming to. If I could just comment on your report on what Chairman Volcker said, I think that what he said is correct. To what degree is very hard to judge. But, again, as it applies to long-term rates. It is very hard for me to see why 3-month Treasury bill rates should be affected in any way by future expected inflation higher than the inflation rates that we actually observe. After all, this is a short-term security that is going to mature within 3 months. We know what the inflation rates are now. There is a wide consensus on the near-term forecast of inflation rates. Therefore, I think it is very hard to explain the high short-term interest rates by invoking inflationary expectations much above current inflation rates.

Long-term interest rates may well have a component of inflationary expectations. Just how big it is is a debatable question. In my own view, the principal influence on long-term rates is actually short-term rates rather than inflationary expectations. It is a complicated argument.

Let me go on to try to answer your question directly.

MONETARY POLICY RESPONSIBLE FOR STRONG DOLLAR

If, as I suggested, the large future budget deficits are not the primary cause of the strong dollar, what is it? I believe that the answer lies in monetary policy. I think that monetary policy remains extraordinarily tight and has remained extraordinarily tight for economic recession and for the early stages of recovery. Admittedly, we are now in the fourth quarter of recovery. But during this period, 1982–83, and even into early 1984, monetary policy has been extraordinarily tight by historical standards. By tight, I mean that real short-term interest rates—which, unlike real long-term interest rates, are actually measurable—have been held at very high levels compared with all previous postwar recessions and early recoveries.

Under a system of flexible exchange rates, the exchange rate is an important channel of influence of monetary policy both on the price level and on economic activity. We have not really absorbed the importance of the exchange rate. We have damped inflation, as Stan Fischer has emphasized, and we have damped recovery by the exchange rate. Tight monetary policy means a strong dollar, which reduces inflation while the currency is appreciating, and increases import competition when it is strong. But we will have to pay for having used this channel of influence. We are paying now with a large trade deficit and the influence that that has on some sectors of the economy, and it is a drag on recovery. And we will have to pay later at some time in the form of greater inflationary pressures than we would otherwise have as the dollar declines in value, in order to reduce our need to borrow abroad so heavily.

To point out that monetary policy has been extraordinarily tight is not the same as suggesting that there is a simple solution to current problems. Monetary policy was tightened and kept tight to reduce actual and expected inflation. And it has succeeded, albeit at the cost of a deep, long, and wasteful depression in output below the economy's capacity to produce and at the cost of a record trade deficit.

EXPAND MONETARY POLICY

I have in my written statement some suggestions to the Fed about how I would lean on the side of easier monetary policy. I do suggest that we should step on the accelerator vigorously. But I would err on the side of expansion. I suggest in particular that the Fed might consider a much more active intervention in foreign exchange markets. That is a somewhat technical issue, which in one sense is monetary policy, but because it would mark a sharp break with past practice, could be differentiated from ordinary monetary policy and could serve to reduce the strong value of the dollar. The dollar is going to come down sooner or later, in my judgment. It would be better to get it down sooner and to ease it down, if we can, than to have it fall precipitously and then have to react to the uncertainties that that creates in markets and around the world in a way that may abort the recovery.

I will end on one line of thought that links the budget deficit to the Fed. To summarize, my view is that it is tight monetary policy that is the principal reason by far for the strong dollar, not the large current or future budget deficits. However, one has to entertain the possibility that in the presence of firm, clear, decisive action to reduce outyear budget deficits, which I favor for other reasons, the Fed would find it easier to ease up on monetary policy. That is yet another reason for getting the outyear budget deficits under control.

I have not however seen any statement either from the administration or from the Fed that suggests that that kind of deal is in fact possible. Indeed, it is not consistent with the current monetarist leanings of the Fed, whereby some variant of the money supply, is targeted come hell or high water, regardless of what happens to the budget deficit. And chairman Feldstein has explicitly rejected the idea that lower budget deficits could permit easier monetary policy. But I do not believe that the Fed is dogmatically monetarist. It may be that in the context of clear, firm action to reduce outyear budget deficits, the Fed would find it easier to lean on the side of expansion, which I think is desirable for them to do, in order to ease the dollar down.

Thank you, Mr. Chairman.

Chairman Domenici. Thank you very much.

Without objection, your written statement will be inserted.

[The prepared statement of Dr. Cooper follows:]

February 1984

The Budget and the Outlook for the Dollar

Richard N. Cooper
Boas Professor of Economics
Harvard University

On a U.S. trade-weighted basis, the U.S. dollar is stronger now than it has been at any time in the last fifteen years. The same is true for the "real" exchange rate, corrected for differential inflation rates in the major industrial countries. In particular, it is stronger than it was just before the Smithsonian agreement, which first devalued the dollar in December 1971. Some estimates place the dollar as being "overvalued" by more than 25 percent. I do not want to get into debate on the essentially semantic question of whether a currency can be "overvalued" in a period of flexible exchange rates. But the dollar is unquestionably stronger than it has been for over a decade, and that has important consequences for our trade position and for the U.S. economy.

The principal observable result is a huge merchandise trade deficit, running at annual rates of nearly $90 billion in the last quarter of 1983. After allowance is made for net earnings on overseas investments and other services, the U.S. is now running a current account deficit on the order of $50 billion, and rising. To put this deficit into overall perspective, the biggest current account surplus that the U.S. has run since 1950 was 1.1 percent of GNP, in 1964. Until last year, the largest current account deficit was 0.7

percent of GNP, in 1978--a deficit that was itself the source of considerable alarm around the world at that time. Data for all of 1983 are not yet available, but the recorded current account deficit will probably approximate 1.1 percent of GNP, the largest since we have kept records of the balance of payments. Put in other words, we apparently borrowed over one percent of GNP from the rest of the world. In fact, there have been substantial statistical discrepancies in the U.S. balance-of-payments accounts, with large net unrecorded receipts in 1982. This statistical discrepancy seems to have declined sharply in 1983, but nonetheless there is probably some overstatement of the deficit due to some under-recording of service transactions.

The huge trade deficit is due partly to the rapid U.S. recovery since the end of 1982, relative to a more lackluster recovery in other industrial countries and an actual downturn in a number of debt-ridden developing countries. This worsening trade balance represents the transmission of U.S. recovery to the rest of the world that foreigners are waiting for. It is the mechanism by which buoyant U.S. economic activity gets diffused abroad. But the worsening U.S. trade balance is also due partly to the strong dollar. U.S. firms find great difficulty competing both at home and abroad. The deficit may decline temporarily as recovery picks up in the rest of the world, but most of it will remain. Moreover, as the United States borrows more and more from the rest of the world, our interest payments to foreigners will rise, and that by itself will tend to worsen the current account deficit even further.

Apart from the anomaly of a capital rich country such as the United States borrowing so heavily abroad, there are two serious problems with this large deficit. The first is that U.S. business firms and labor unions will confuse the consequences of a strong U.S. dollar with "unfair trade practices" abroad, and appeal for protection from imports. There are many foreign practices which are different from ours; that does not automatically make them unfair, they have often existed for a long time and we would ingnore them if we could compete fully with the foreign products. But with such a strong dollar, attention is drawn to all kinds of practices which seem to give foreign products a special competitive advantage, and U.S. firms will appeal under U.S. law for such protection as they can get, including under the provisions covering unfair trade practices.

Moreover, under the Trade Act of 1974 escape clause action (section 201) is possible so long as a U.S. industry has been injured and imports are a substantial cause of the injury-regardless of the cause of the imports. A former provision linking increased imports to trade liberalization was dropped in 1974. So we have a setup under which a strong dollar can over time result in a built-in protectionist response. Paradoxically, to the extent that it succeeds and certain imports are in fact restricted, the value of the dollar will simply be driven higher and will thereby worsen the competitive positions of our exports and of import competing industries that do not receive protection. In addition to these provisions under existing law, there will be calls for new congressional or executive branch action to restrict imports, calls that take on a special importance in an election year. Yielding to these various calls for protection could abort the recovery via one of two channels. First, strong U.S. protectionist action might lead to retaliation or merely emulated in other countries (Europe especially comes to mind), leading to a collapse of confidence in the world trading system as happened in 1930-31, following passage of the Hawley-Smoot Tariff. Second, substantial increases in protection in the United States might lead to large scale default on external debts by developing countries who have been told that they must improve their trade positions as a condition for new loans to service and repay their outstanding debts. Unable to increase their exports because of protectionist actions in the United States and elsewhere, countries in heavy external debt might simply cease servicing their debts, thereby throwing the international banking system into a crisis and undermining confidence in the international financial system. The worldwide uncertainties engendered by either sequence of events could lead to a sharp cutback in investment spending, which would abort the recovery.

The second difficulty with deficits of this size is that they require foreigners to lend us currently at the rate of $50 billion a year--chairman Volcker says that it will grow to $80 billion during 1984, and Fred Bergsten suggests that it may be as high as $100 billion--just to cover the deficit. This amount must be reduced by any unrecorded service receipts that we have, but it must be increased by the rapidly growing interest payments that we must make to foreigners as we borrow more from them. In just two or three years at these rates the United States will become a net debtor with respect to the rest of the world, a position it has not had since 1914. In other words, in the short period of three or four years we will have wiped out the huge volume of net claims which Americans built up on the rest of the world during the sixty year period from 1920 to 1980.

Will foreigners be willing to lend this amount to the United States, especially as economic recovery and hence demands for credit increase abroad? My guess is that at some point--it is difficult to say exactly when--foreigners will decide not to lend on this scale to the United States at current interest rates. That would not imply any basic loss of confidence in the U.S. economy, but rather recognition that the current situation cannot be sustained. At that point U.S. interest rates will have to rise, or the dollar will fall, or both. While the dollar is falling, foreigners will hesitate to purchase U.S. securities, so any drop in the dollar is likely to be sharp and substantial as soon as the preferences of asset holders around the world switch away from dollars. At that point the United States will experience a rise in its price level--the repayment of the reduction in the price level that we enjoyed temporarily by having an appreciating dollar during the past several years. And the Federal Reserve may then have to respond by tightening credit if market sentiment moves rapidly against the dollar, markets threaten to become disorderly, and generalized uncertainty spreads throughout the world economy.

What can be done about this situation? The current fashion, led by CEA chairman Martin Feldstein, is to blame the budget deficit and to urge a sharp reduction in that deficit as the way to reduce the strong value of the dollar. What may be called the Feldstein Doctrine suggests that projected future budget deficits lead to high real long-term interest rates, and these in turn lead to a strong dollar relative to other currencies. The logic of this position is impeccable. But what about the magnitudes? Feldstein leaves the impression--I am not sure he has actually said it--that a substantial reduction in future budget deficits will have a substantial effect on today's exchange rates for the dollar, and thereby will improve the competitiveness of both the export and import-competing sectors of the economy.

Secretary Regan, in contrast, sometimes leaves the impression that budget deficits do not matter at all. He errs in dismissing Feldstein's concerns. But he is probably closer to being right on the magnitudes, at least for the moment, when the economy is still operating well below full utilization of its capacities. In my view, agreement today to reduce future budget deficits, will, by itself, have only a negligible effect on today's exchange rates. I believe that Feldstein has identified correctly the causal relationship, but he has exaggerated its magnitude. Agreeing on a reduction of future budget deficits will not, in my view, provide current relief from the strong dollar by itself. (The effect would be much greater if the economy were operating at full utilization of its capacitites, when competition for real resources would be much more acute than it is at present.)

Secretary Regan, on his side, in my judgment exaggerates the role of political factors in inducing foreign capital to come to the United States. There is no doubt that much capital is fleeing from political or economic uncertainties abroad. But capital coming from Latin America cannot explain why the dollar continues to be strong with respect to the Japanese Yen or the German Mark. Moreover, it is difficult to explain the heavy Japanese investment or the heavy British investment that has taken place in the United States during the last several years by invocation of political and economic uncertainties in those countries.

I do not want these views to be interpreted to suggest that I do not attach much importance to the large projected budget deficits. I do, and I believe strongly that steps should be taken to reduce them. But the need to reduce these budget deficits in my view is largely for domestic reasons. Reduction of deficits is necessary to impose some discipline on the various programs for government spending. In the long run, taking one year with another, government spending should be covered by taxation. Second, large budget deficits impose major impediments to real investment as the economy reaches full utilization. Third, continuing larger deficits with rapidly growing debt servicing requirements introduce an important element of instability into the economy, since a growth in debt service in excess of the growth in GNP cannot continue indefinately.

The immediate impact of budget deficits on the exchange rate and hence on the trade balance is relatively limited. Of course, as the economy approaches fuller utilization of its resources, then the link between the budget deficits and the external deficit becomes closer, and that is an issue which we will have to worry about in the future. But the large external deficit is with us already, and generally speaking it is only very loosely related to the large budget deficit that we now have.

If large future budget deficits are not the cause of the strong dollar, what is it then? I believe the answer lies in monetary policy, which remains extraordinarily tight for economic recession and the early stages of recovery. By tight I mean that real short-term interest rates, which unlike real long-term interest rates are measurable, have been held at very high levels compared with all previous post-war recessions and early recoveries. Under a system of flexible exchange rates, the exchange rate is an important channel of influence of monetary policy both on the price level and on economic activity. We have damped both inflation and recovery via the exchange rate. Tight monetary policy means a strong dollar, which reduces inflation while the currency is appreciating and increases import competition when it is strong. But we will have to pay for having used this channel of influence. We are paying now with the large trade deficit and the influence that it has on some sectors of the economy, and we will have to pay later in the form of somewhat greater "inflationary" pressures than what we would otherwise have as the dollar declines in value in order to reduce our need to borrow so heavily abroad.

To point out that monetary policy has been extraordinarily tight is not the same as suggesting that there is a simple solution to current problems. Monetary policy was tightened and kept tight to reduce actual and expected inflation; and it has succeeded, albeit at the cost of a deep, long, and wasteful depression in output below the economy's capacity to produce and at the cost of a record trade deficit.

The Fed must be ever watchful about rekindling inflationary expectations, which could undo some of the costly gains that have been achieved. Can the Fed pursue easier monetary policy without rekindling inflationary expectations? I do not know, but I believe that Fed should be constantly probing on the side of expansion. We are now experiencing the enormous cost of having persuaded the financial community that a perfectly respectable long-run equilibrium theory, appropriate for the stationary state of the economics textbook, is also appropriate for the quarter-to-quarter or even the week-to-week management of an actual economy. In his grave Keynes can take satisfaction at another powerful illustration of his statement concerning the influence of ideas, good or bad, on men of affairs. It is up to the academic community to begin the process of reeducation away from a simplistic monetarist view of how monetary policy exerts its influence on a real national economy. But in the meantime the Fed must take into account the jumpy and misguided expectational effects concerning week-to-week movements in the money supply.

One way to probe on the side of expansion is to engage in exchange market intervention, a course that the administration discards much to hastily. Exchange market intervention in the right setting can have an influence on exchange rates. Unsterilized intervention is really simply one form of monetary policy. Unsterilized purchases of foreign currencies by the Fed would increase the money supply, but the announcement of an intention to reduce a dollar that is widely recognized as too strong might well be received quite differently, and more favorably, by financial markets than would just another weekly increase in the money supply generated in the usual way.

Even sterilized intervention can have some effect on exchange rates, however--partly by altering the composition of the dollar and non-dollar assets in private hands in the world, but much more by signalling that the U.S. authorities are not indifferent to the exchange rate and are prepared to take steps to influence it. In this regard, for example, the U.S. authorities could take advantage of recent trends in exchange markets to "lean with the wind" and push the dollar even further back toward a sustainable level. Given the central role of the dollar in the world financial system, any major intervention should be undertaken in close collaboration with other leading countreis, including the orchestration of the announcement effects. But in markets that are heavily influenced by expectations--something that is implied by the Feldstein Doctrine concerning budget deficits--skilfully handled intervention could become an important supplement to monetary and fiscal policy.

Chairman DOMENICI. It is kind of a crazy thing to ask you here in public, but do you know of a little basic primer on foreign trade and foreign exchange rates that we might circulate among interested people up here? I think there is more confusion and lack of information on what the trade deficit means, what the capital inflow situation is and how it is impacted than almost anything else. We are just beginning to understand the Federal Reserve and even that not as much as we should. But, on the other, we are getting a lot of different views.

Certainly I do not tell you today, from what I have heard, being a novice at it, that yours sounds better than others; but clearly it is at least understandable.

Do you know of something that we might use to circulate to explain the different views on that, Dr. Cooper?

Dr. COOPER. Not offhand, but let me give it some thought.

Chairman DOMENICI. We would be most appreciative.

Dr. COOPER. I will give a plug for a textbook by Stan Fischer and Rudy Dornbush, which has some discussion of this in it.

Chairman DOMENICI. That is too much.

Dr. COOPER. It is a big book.

Chairman DOMENICI. I know you did not expect the chairman of the Budget Committee to ask you this question today, so I understand why you are not prepared to step right up and give me one.

We are delighted to have you, Dr. Friedman. Would you like to proceed?

Did you have a question, Senator Gorton?

Senator GORTON. No, Mr. Chairman.

STATEMENT OF DR. BENJAMIN M. FRIEDMAN, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

Dr. FRIEDMAN. Thank you, Mr Chairman. I am very pleased to be here.

I have submitted a fairly lengthy written statement. Rather than read it, I will simply summarize the principal points that I make.

Chairman DOMENICI. Without objection, we will make that statement part of the official record.[1]

Dr. FRIEDMAN. The main conclusion of the statement that I have submitted, sir, is that the current course of fiscal policy in the United States, including the tax and spending policies of the Federal Government, is going to prove severely damaging to the U.S. economy unless we change it very soon. I believe that this damage is going to come in two forms.

The first is that the financing requirements of the Federal deficit, as we move through fiscal years 1985, 1986, and 1987, are going to impair, and impair very sharply, our economy's ability to undertake fixed capital formation. If we continue the tax and spending policies that we now have, both business capital formation and also residential capital formation will suffer substantially.

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[1] See p. 612.

FIXED CAPITAL FORMATION RATE LOW

On the business side, that prospect is extremely unfortunate for reasons having to do with our economy's long-run competitiveness, its productivity, and the growth in the standard of living that we can deliver to the average worker and citizen. The U.S. economy has had a very low rate of net capital formation in comparison with other countries for many years. What is new today is that our fixed capital formation rate is extremely low, even in comparison to our own rather meager prior experience. I believe it is true that 1983 saw the worst performance of any year since World War II for net business capital formation in the United States. We invested only 1 percent, one one-hundredth, of our gross national product in net additions to business plant and equipment in 1983, after allowance for depreciation and obsolescence. That is not only far below what any competitive foreign economy has done, it is also way below our own prior experience. It even comes dangerously close to having a negative net rate of capital formation, meaning that our economy's productive base would be shrinking rather than growing. This is a very severe situation. It will probably improve somewhat during 1984, because of the business recovery, and perhaps even during 1985. But any real chance of improving the situation as we continue on will simply be vitiated by the financing requirements of the Federal Government.

Chairman DOMENICI. Doctor, do the words "net capital formation" mean what you just said, as far as normal and accepted definition?

Dr. FRIEDMAN. Yes, sir, I believe that is correct.

Chairman DOMENICI. That means the amount invested by business in capital improvements equals net capital investment?

Dr. FRIEDMAN. Yes, sir. Sometimes we look at a total which also includes the replacement of depreciation; that would be called gross capital investment. But what matters for growth of the economy's productive capacity is, the net additions over replacement. It is the net additions that were a smaller share of the economy last year than in any year since World War II.

RESIDENTIAL CAPITAL FORMATION WILL BE SQUEEZED

A further aspect of capital formation that will also be squeezed, and quite severely, by the fiscal policy now in place is residential capital formation. That is a different matter, but it still bears a very negative implication for the ability of our economy to deliver what our citizens want. We have a growing population. We have net household formation at a fairly high level. A growing population requires an increasing housing stock. Today we have a very low rate of net additions to our housing stock.

In sum, one of the two principal areas in which the current fiscal policy will prove severely damaging to our economy is the whole area of fixed capital formation.

The second area is the damage that it does to the foreign competitive sector. Here I agree with what my colleague, Professor Cooper, said, and I will simply omit any further reference to this subject, not because I think it is unimportant—I think it is very important—but simply because I agree with what Professor Cooper said.

The key issue, today is whether the President's budget, submitted earlier this month, makes a positive contribution to alleviating this problem. I think the answer is simply no. I see nothing in the proposals that the President has submitted that shows any serious prospect of making progress in alleviating the situation that we now face.

I will come back to some suggestions of what I think we should do. But for now I will simply say that the President's proposals do not stand up to any real notion of what is required.

The basic story of how this damage to our fixed capital formation and to the economy's foreign competitive sector will come about is fairly familiar. The deficit that we now have is in excess of 6 percent of our gross national product. Projections for the future by, for example, the Congressional Budget Office, which look fairly sensible to me, suggest that we are likely to have deficits of about this magnitude for the foreseeable future if current policies are continued; indeed, the deficits may increase.

The relevant benchmark, is that net private saving in our economy, that is, the saving of all individuals and businesses, over and above depreciation and obsolescence, is only 7 percent of GNP.

FEDS PREEMPTING FINANCIAL RESOURCES

The Federal Government, therefore is now preempting $6 out of every $7 that individuals and businesses make available to contribute toward their future. That is a very heavy slice out of the Nation's economic pie.

As a result of this preemption of financial resources, the Federal Government deficit has very severe effects on the allocation of real resources. What happens in the financial markets not only can but does importantly affect allocations of real economic activity. That is exactly what we already see happening in the foreign competitive sector. By next year or the year after, we will see it happening also in the economy's investment sector.

High real interest rates and high real exchange rates are the principal mechanisms by which these effects from the financial markets on the economy's real markets come about. The resulting real economic outcomes are less capital formation, fewer exports, and more imports.

Before going in to talk about to what should be done, I would like to take just a few moments to address several answers that I consider to be easy but wrong answers to the problem we face. Anytime we face a problem this severe, it should be pretty obvious that there are no easy and correct answers, because if there were easy but correct answers somebody would have implemented them already.

But there are some easy answers that are easy but wrong. I would like to say briefly why these answers are wrong, because one of the greatest impediments to making a difficult but correct step is the belief that there is some easier thing to do. I will discuss four of them.

LOWER TAX RATE DOES NOT STIMULATE SAVINGS

The first easy but wrong answer is that the lower tax rates that Congress legislated in 1981 will so stimulate saving in our economy to enable us to finance not only large budget deficits but also a healthy rate of net capital formation. I think that idea is wrong for several reasons.

The Economic Recovery Tax Act of 1981 actually contained relatively little in the way of specifically targeted saving incentives. The expanded IRA and Keogh provisions were an important and potentially useful step in this regard. Lowering the maximum rate on investment income from 70 to 50 percent was also important. Nevertheless, the preponderance of the revenue that was returned to the public by the Treasury under the 1981 legislation simply consisted of across-the-board tax reductions on the incomes of people whose tax rates went down, say, from something in the thirties to something in the high twenties.

There is simply no evidence, that rate reductions of this kind have any significant impact on saving. Indeed, one of the puzzles of modern empirical economics is that we have been so unable to find significant effects of after-tax yields on saving.

Many people have attempted to find evidence of these effects, but we do not know whether the effect of higher after-tax yields on saving is even positive, much less that it is large. In comparison with the huge increase in saving that would be required to finance both the budget deficit and also a net capital formation rate comparable to our historical experience, I think that the notion that we should solve the problem with a higher saving rate is simply wrong.

NO CONNECTION BETWEEN BUSINESS CASH FLOW AND INVESTMENT

The second easy, but wrong answer, is that large business profits earned in the course of the current recovery, together with the expanded business cash flow from accelerated depreciation under the ACRS system, will provide sufficient business cash flow that, even though residential capital formation would decline, business capital formation in plant and equipment will be able to continue without much business reliance on the capital markets.

This answer is wrong also. It is wrong because, in the first instance, there is no direct connection between business cash flow and business investment in plant and equipment. Businesses pay out some of their cash flow in the form of higher dividends; businesses use some of their cash flow to finance mergers and acquisitions; and, finally, there is some evidence that individuals who own corporate equities actually reduce their personal saving to compensate for the additional saving that businesses do in their behalf.

Adding up all of these influences, I think it is very unlikely that we can sustain an acceptable capital formation rate simply on the basis of business profits and ACRS depreciation.

CAPITAL INFLOWS MIRROR CURRENT ACCOUNT DEFICITS

The third easy, but wrong answer, is that the Government's deficit would be a problem if ours were a closed economy, but it is not a problem because we can finance the Government deficit by sale of securities to foreigners. I can be brief here because Professor Cooper has dealt with this subject in some detail. I will simply point out, as he already has, that financial capital inflows mirror balance of payments deficits on current account. Large capital inflows mean that our current account is deeply in deficit. From the perspective of the foreign-competitive sector, therefore, solving the problem by capital inflows is a way of scoring points by giving away the game. The damage done to the economy through a deteriorating current account balance is simply the mirror image of the advantage, if it is that, associated with selling securities to foreigners.

In addition, there is the further problem that the U.S. economy is in a very anomalous position in being one of the world's richest economies, but now moving into a net debtor situation. If the U.S. economy were embarked on a major investment boom, and was running a current account deficit as a way of financing that investment because people around the world thought that it was better to put up new plant and equipment here than to do so in Europe or Asia or Latin America or Africa, then that might possibly be an excuse for us to be a net borrower nation. For us to be a net borrower nation for the purpose of financing government and private consumption, however, strikes me as entirely unacceptable.

CLAIMING NOTHING NEW IN TRENDS IS WRONG

The fourth simple, but wrong answer, is not really an answer, but a notion of despair. One hears often that what is going on now is not new, that it is simply the logical extension of trends that have been in place since the 1960's, or perhaps even since the 1930's.

That notion is interesting but wrong. It misses entirely the sharp discontinuity in our experience that we have undergone just within the past few years. Until the 1970's the U.S. Government rarely if ever ran a deficit in its budget as large as 1 percent of the GNP. In the 1970's the average deficit was about 2 percent of the GNP, but by far the greatest part of that was simply the automatic response to the periodic episodes of a weak economy, especially in 1975 and 1976 after the first OPEC recession. On a high employment basis, the U.S. Government's budget was typically very close to being in balance in those days. What is new now is that we have these very large deficits, far beyond anything in our previous peacetime experience, and moreover that they are large deficits even on a high employment basis as we look forward.

To claim that there is nothing new, and that this situation is a mere outgrowth of trends begun in the sixties or even the thirties, entirely misses the point that what we have now is new, is damaging, and is damaging in a way that our economy has never seen before.

What should we do? I offer the following set of suggestions, which I think are not at all radical, but which I think would make a very positive contribution to the problem.

FISCAL YEAR 1985 GOOD TIME TO REDUCE DEFICIT

First, we should reduce the deficit. Everybody knows that.

Second, when should we do that? I believe that fiscal year 1985 is in no way too early to begin. Many people continue to speak as if our economy is still a long way away from relatively full employment of its resources, and as if it is likely to remain so for the foreseeable future. That view has not caught up with the speed of the recovery we have enjoyed within the past year. The unemployment rate was close to 11 percent at the trough of the recession in late 1982. The unemployment rate is now under 8 percent, and headed downward. Capacity utilization in manufacturing was below 70 percent at the trough of the recession. Capacity utilization is now 79.9 percent, and rising. If we look forward to fiscal year 1985, and especially if we recognize that policy actions have delayed effects on the economy so that fiscal year 1985 actions are likely to have their principal effects on the economy in 1986—that is, 2 years from today—then it is clear that fiscal year 1985 is not too early to think about problems that would not be problems if we continued to have an ample cushion of unused resources.

How much should we reduce the deficit? In my written statement I suggest two different ways of looking at this problem. Both yield approximately the same answer. One answer is to go back to the 1970's, as the best achievable result, and to ask what share of GNP, and therefore what share of the Nation's saving, the Federal Government deficit was preempting in those years. On average in the 1970's the deficit was about equal to 2 percent of the gross national product. Hence one answer would be to say that, within some feasible time frame like, for example, the 1987 fiscal year, we should shrink the deficit back to only 2 percent of gross national product.

STABILIZE DEBT TO GNP RATIO

The second approach focuses not on the size of the deficit but on the amount of borrowing that the Federal Government has accumulated over the years; in other words, on the outstanding Federal debt relative to GNP. Here is the area, I think, in which we notice the sharpest discontinuity with the past.

The U.S. Government emerged from World War II with an outstanding debt that was more than dollar for dollar with the GNP. As the next 35 years progressed, the Federal Government increasingly paid down that debt in relative terms. The Government did not pay down the debt in absolute terms, of course, because it was not running surpluses on average, but it paid down the debt in relative terms, in the sense that the deficits were small enough, with the exception of a few recession years, that the outstanding debt grew more slowly than the GNP grew. As a result, from the end of World War II until only a few years ago the Federal debt continually shrank, from dollar to dollar with GNP to only about 28 cents per dollar of GNP a few years ago.

Now, in the 1980's, the Federal debt is rapidly rising in comparison to GNP. It is up to 35 cents on the dollar now. Even the Reagan administration's projections, which in my judgment are overly optimistic on economic assumptions as well as unrealistic on some spending assumptions, project a rise in the Federal debt to GNP ratio back to 40 cents on the dollar within the next few years. More realistic projections, like those of the Congressional Budget Office, indicate a rise to 49 cents on the dollar by the end of the decade. This is a very dramatic reversal of what we were doing for the other years in the postwar period until 1980, and it has very negative implications for capital formation along the lines that I indicated a moment ago.

My suggestion in this regard would be to reduce the Federal deficit, on average during the next, say, 5 years, to the point at which we could at least stabilize the Federal debt to GNP ratio, absorbing the damage that the policies of the early eighties have already done, but at least avoiding any further increase. That would imply reducing the deficit to an average of about $100 billion per year—or, coincidentally, about 2 percent of the GNP—on average over the next 5 years.

ADOPT A ONE-THIRD STRATEGY

Senator **CHILES**. What would that be dollar for dollar of GNP in relation to this 28 cent figure?

Dr. **FRIEDMAN**. Senator, this would stabilize the debt ratio at about 35 cents on the dollar. At the end of the 1983 fiscal year last September 30, the ratio was 35.5 cents of Government debt per dollar of GNP. This would just freeze it there, rather than allow it to climb further.

How would we do that? My suggestion would be to adopt a rough one-third, one-third, one-third strategy. If, for example, we pursued the 5 percent real increase in defense spending that the chairman of this committee has suggested, that would in itself amount to about one-third of what is needed. I would then suggest also accounting for about another third through reduced spending on nonmilitary items. And, finally, I think we need a tax increase to account for the other third.

3-YEAR TAX CUT WAS A MISTAKE

In calling for a tax increase, I think it is important to raise taxes in ways that do not depress saving and investment, and I have a very specific proposal in that regard. I believe that the time has come to recognize that the 3-year tax cut legislated in 1981 was quite simply a mistake.

Many people said in advance that it was a mistake. The majority leader of the Senate called it a "river boat gamble." Other Senators made similar comments. I am astonished that, since so many people knew and said in advance that it was a mistake, now that it is in place so many of the same people are reluctant now to say that it was a mistake and that it should be changed. My suggestion is to recognize that we made a mistake and to change it.

We should be careful not to eliminate provisions of the 1981 Economic Recovery and Tax Act that are helpful from the perspective of stimulating saving and investment. For example, the increased IRA and Keogh account provisions should not be eliminated. The maximum rate should stay at 50 percent. But the final year's 10 percent cut in tax rates would, if reversed, just about account for the other one-third of the deficit reduction package that is needed.

I see no evidence that that final 10 percent rate cut has had any stimulating effects on saving and investment, nor do I believe it would, and I think we should simply reverse it.

Mr. Chairman, thank you very much.

Senator CHILES. Thank you, Doctor.

[The prepared statement of Dr. Friedman follows:]

February 29, 1984

TESTIMONY BEFORE THE UNITED STATES SENATE COMMITTEE ON THE BUDGET

Benjamin M. Friedman

Professor of Economics
Harvard University

Mr. Chairman:

I am grateful for the opportunity to present my views to this committee as it assesses the prospects for the U.S. Government's budget deficit in the years immediately ahead and considers ways of narrowing that deficit. Under a continuation of current federal tax and spending policies, the effects of the government deficit in the financial and foreign exchange markets will pose a major threat to the economic well-being of the United States. This committee's search for a solution to the problem is an effort well undertaken.

Widespread concern, even alarm, over the U.S. Government's budget deficit has become one of the leading public policy issues of the decade. Talk about large federal deficits that will persist through the 1980s now dominates discussions otherwise intended to focus on specific spending needs — defense, for example, or medical care supports — or on tax restructuring. It also now dominates discussions about the proper course for monetary policy, about the effect of the dollar's international exchange rate on U.S. competitiveness, and about the outlook for the U.S. economy's continued expansion.

These fears are warranted, at least in part. To be sure, much of the discussion has not been carefully put, and some of the ideas expressed have been simply wrong. The chief problem in this regard has been the failure to distinguish clearly between passive deficits that emerge as a result of depressed levels of economic activity and fundamental deficits that persist even when the economy's labor and capital resources are fully employed. Many of the most frequently expressed criticisms of the U.S. Government's deficit during fiscal years 1981-83, when economic weakness accounted for much of the deficit that the government then ran, were either largely or wholly misguided. By contrast, the deficits in prospect for fiscal years 1984-88 are indeed cause for concern.

The basic problem is that, under current policies or most of those now under active consideration, during 1984-88 the U.S. Government will continue to run budget deficits at or near the recent unprecedented levels, even if the economy returns to a fully employed condition. (This prospect actually extends well beyond the next half-decade, but official estimates are available only through fiscal year 1988.) Increasingly during these years, the deficit will reflect a fundamental imbalance between the government's revenues and expenditures at full employment, rather than a passive response to economic weakness as was the case during the past several years. If for some reason the U.S. economy continues to fall well short of full employment of its resources, then the average deficit realized during 1984-88 will be all the greater.

The principal reason why this indefinite continuation of unprecedentedly large U.S. Government budget deficits is a problem is that, by sharply curtailing or even eliminating altogether the economy's net investment in new plant and equipment, it will cut deeply into the economy's ability over time to achieve improved productivity and hence a higher general standard of living. The U.S. economy's net capital formation rate is already low in comparison either with the economy's own past experience or with that of major industrial economies abroad. A further erosion, of the magnitude likely to accompany the government deficits now in prospect for the balance of the 1980s, will be a step in the wrong direction.

A second important reason why the deficits now in prospect represent so great a problem is that their effects in the foreign exchange markets will continue to keep the dollar at a value highly disadvantageous to U.S. businesses either exporting goods abroad or competing at home against foreign imports. The recent sharp rise in the dollar's real exchange rate is almost surely the chief reason (although there are others as well) underlying the flagging international competitiveness of the U.S. economy. All current signs indicate that this problem will become worse, rather than better, in the near term. Continued large federal budget deficits as the economy expands will further exacerbate the already serious difficulties of the economy's international sector.

What is the Problem?

Even after the recent improvement in the U.S. economic outlook, there appears to be little prospect for a significant reduction in the U.S. Government's budget deficit during the remainder of the 1980s unless tax and spending policies change sharply (see Table 1). Current services baseline projections show an increasing deficit until 1988. The alternative policy proposals advanced either in the Administration's Budget message or in the Congressional Budget Resolution, once adjusted to eliminate new tax plans as yet commanding uncertain support, preclude further deficit growth but provide little shrinkage either. Further adjusting either set of proposals to allow for a realistically likely amount of slippage in holding to the stated spending targets would only worsen the

TABLE 1

PROSPECTS FOR THE U.S. GOVERNMENT DEFICIT, 1984-88

		1984	1985	1986	1987	1988
Current Services:	Budget Proposal	$249	$267	$284	$308	$315
	Midsession Review	217	220	233	244	224
Reagan Budget:	Budget Proposal	203	205	157	152	126
	Midsession Review	194	181	139	128	91
Adjusted Reagan:	Budget Proposal	203	205	203	201	177
	Midsession Review	194	181	182	177	144
Congressional Resolution		200	190	157	—	—
Adjusted Congressional Resolution		212	205	203	—	—

Notes: Deficits in billions of current dollars.
Deficit totals include "off-budget" outlays.
Years indicated are fiscal years.
Source: Office of Management and Budget, Congressional Budget Office.

corresponding deficit prospects. The deficits projected today are also extraordinarily large even in comparison to the U.S. economy's expanding total size (see Table 2). None of the projections that are most relevant shows a deficit materially below 4% of gross national product before 1988.

Sustained government deficits of this magnitude, either in dollars or in relation to gross national product, will be unprecedented in U.S. peacetime experience. Despite the often expressed claim that the government's budget has "always" shown a large deficit, in fact persistent deficits larger than 1/2 % of gross national product have been a feature of U.S. fiscal policy only since the 1970s (see Table 3). Until 1982 the deficit had exceeded 3% of gross national product only during 1975 and 1976, in the wake of the severe 1973-75 business recession. Analogous effects of the 1981-82 recession have now swollen the deficit to more than 4% of gross national product in 1982, and more than 6% in 1983. Unlike these relatively isolated episodes of large deficits in the past, which largely reflected the shortfall of tax revenues and increase in transfer payments due to declining employment, incomes and profits in times of recession, the deficits now projected for the balance of the 1980s will increasingly represent a budget that will be unbalanced even at full employment. By contrast, economic weakness has accounted for some three-quarters of the total cumulated deficit run during the last three decades, leaving only one-quarter as a result of expenditures and revenues that would have been unequal at full employment (see Table 4).

This difference between the actual and high employment budget concepts is especially important in determining what magnitudes constitute the outer limits of the U.S. economy's prior experience. In 1975 and

TABLE 2

PROSPECTIVE DEFICITS AS PERCENTAGES OF GNP, 1984-1988

		1984	1985	1986	1987	1988
Current Services:	Budget Proposal	7.1%	7.0%	6.9%	6.8%	6.4%
	Midsession Review	6.1	5.7	5.5	5.3	4.5
Reagan Budget:	Budget Proposal	5.8	5.4	3.8	3.4	2.6
	Midsession Review	5.5	4.7	3.3	2.8	1.8
Adjusted Reagan:	Budget Proposal	5.8	5.4	4.9	4.5	3.7
	Midsession Review	5.5	4.7	4.3	3.9	2.9
Congressional Resolution		5.6	4.9	3.7	—	—
Adjusted Congressional Resolution		6.0	5.3	4.8	—	—

Notes: Deficits as percentages of projected gross national product.
Deficit totals include "off-budget" outlays.
Years indicated are fiscal years.
Source: Office of Management and Budget, Congressional Budget Office.

TABLE 3

HISTORICAL U.S. GOVERNMENT DEFICIT, 1951-1983

	Deficits in Billions of Current Dollars	Deficits as Percentages of GNP
Average, 1951-60	$ 1	0.0%
Average, 1961-70	6	0.5
Average, 1971-80	31	2.4
1971	23	2.2
1972	23	2.1
1973	15	1.2
1974	6	0.4
1975	53	3.6
1976	73	4.5
1977	54	2.9
1978	59	2.8
1979	40	1.7
1980	74	2.9
1981	78	2.8
1982	128	4.2
1983	208	6.4

Notes: Deficit totals include "off budget" outlays.
Years indicated are fiscal years.
Source: Office of Management and Budget.

TABLE 4

HISTORICAL DEFICITS ON A HIGH EMPLOYMENT BASIS, 1955-1983

	Deficits in Billions of Current Dollars	Deficits as Percentages of Potential G[illegible]
Average, 1955-60	-$ 6	-1.0%
Average, 1961-70	-0	-0.1
Average, 1971-80	13	0.8
1971	9	0.9
1972	10	0.9
1973	14	1.1
1974	5	0.3
1975	15	1.0
1976	21	1.2
1977	19	1.0
1978	20	1.0
1979	2	0.1
1980	18	0.7
1981	-7	-0.2
1982	19	0.6
1983	57	1.6

Notes: Deficits are on a national income and product accounts basis.
Negative values indicate surplus.
Years indicated are fiscal years.
Source: U.S. Department of Commerce.

1976, for example, the actually realized deficits of $53 billion and $73 billion corresponded to high employment deficits of $15 billion and $21 billion, respectively. In 1981 the budget would have shown a small surplus if the economy had been fully employed, and in 1982 the actually realized deficit of $128 billion would have been only $19 billion at high employment. In comparison to the economy's size, the largest high employment deficits run during the last three decades were 1.5% and 1.9% of potential gross national product in 1967 and 1968, respectively. It is clear that prospects for the remainder of the 1980s are well outside this prior experience.

What is extraordinary about the U.S. Government deficits now projected for 1984-88, therefore, is not just that they will be large but, more importantly, that they will represent a fundamental imbalance between the government's revenues and its expenditures. It is not possible to dismiss them simply by assuming that rapid growth will quickly restore the economy to full employment. The projected deficits are increasingly deficits at full employment, and in the absence of a return to full employment the deficits that actually emerge will only be larger. The issue now facing U.S. fiscal policy is not the familiar one of the role of automatic stabilizers, or even the desirability (or lack thereof) of temporary active deficits as discretionary stabilizers, but rather the effects of sustained deficits at full employment as a permanent feature of the economy's ongoing development. Among the most important of those effects is the impediment that such deficits will place in the way of the economy's ability to undertake capital formation.

Why Deficits Matter: Saving and Investment

The economy's net private saving, consisting of personal saving plus corporate retained earnings, represents the share of total output that the private sector as a whole makes available to finance new investment beyond what is necessary simply to replace depreciating stocks of business and residential capital. Despite substantial variation since World War II in such factors as tax rates, price inflation, real rates of return and income growth trends — all of which could in principle affect saving behavior — the U.S. economy's net private saving rate has remained very steady throughout this period (see Table 5). Its post-war mean has been 7.2%, with a standard deviation around the mean of only 1%, and it has displayed no significant time trend during this period (once the data are corrected for cyclical variation). It has varied in a modestly procyclical pattern, however, which accounts for the slightly higher than average saving rate during the 1960s and (in part) for the distinctly lower than average saving rate thus far during the 1980s.

If government budgets were always balanced (and if the foreign account were balanced too), the share of the economy's output available for net capital formation would simply be the share set aside as net private saving. Given the experience since World War II, that would mean a relatively steady 7% of gross national product over time. In the presence of government surpluses or deficits, however, what is available for net investment is net private saving plus any government surplus, or less any government deficit.

In recent years public sector saving and dissaving has played an increasingly prominent role in affecting the U.S. economy's overall saving and investment balance (see again Table 5). Since the 1970s state

TABLE 5

U.S. NET SAVING AND INVESTMENT, 1946-83

	1946-50	1951-55	1956-60	1961-65	1966-70	1971-75	1976-80	1981	1982	1983
Total Net Saving	10.3%	6.8%	6.9%	7.4%	7.6%	6.4%	5.7%	5.1%	1.5%	1.1%
Net Private Saving	7.6	7.2	7.1	7.8	8.1	7.6	6.5	6.1	5.3	5.1
Personal Saving	4.0	4.7	4.7	4.3	5.0	5.6	4.2	4.6	4.1	3.3
Corporate Saving	2.6	2.5	2.4	3.5	3.1	2.0	2.3	1.5	1.2	1.8
State-Local Govt. Surplus	0.1	-0.1	-0.2	0.0	0.1	0.6	1.2	1.2	1.0	1.4
Federal Govt. Surplus	2.6	-0.3	0.0	-0.4	-0.6	-1.8	-2.0	-2.2	-4.8	-5.4
Total Net Investment	9.6%	7.4%	6.6%	7.6%	7.3%	6.7%	5.8%	5.0%	1.5%	1.0%
Net Foreign Investment	1.4	0.1	0.5	0.8	0.2	0.3	-0.2	0.1	-0.3	-0.6
Private Domestic Investment	8.2	7.3	6.1	6.8	7.1	6.4	6.0	4.9	1.8	1.6
Plant and Equipment	3.8	2.8	2.6	2.9	4.0	3.1	2.9	3.0	1.9	n.a.
Residential Construction	3.3	3.4	3.0	2.9	2.0	2.6	2.4	1.2	0.7	n.a.
Inventory Accumulation	1.2	1.0	0.6	1.0	1.1	0.7	0.7	0.6	-0.8	-0.8
Memoranda: Capital Consumption	7.7%	8.5%	9.3%	8.5%	8.4%	9.3%	10.5%	11.2%	11.7%	12.8%
Gross Private Saving	14.4	15.7	16.4	16.3	16.4	16.9	17.0	17.2	16.9	16.7

Notes: Data are averages (except for 1981-83) of annual flows, as percentages of gross national product.
Data for 1983 are for first half only.
Total net saving and total net investment differ by statistical discrepancy.
Detail may not add to totals because of rounding.
Source: U.S. Department of Commerce.

and local governments, in the aggregate, have run ever larger budget surpluses on a consolidated basis, as current pension surpluses have grown faster than operating deficits. By contrast, during this period the budget deficits run by the federal government have grown progressively larger in relation to gross national product. These two trends have been in part offsetting, but increasingly unequal. By the early 1980s the federal government's deficit had grown far beyond the aggregate surplus of state and local governments. Under any currently relevant projections, it will remain so.

The U.S. economy's total net saving, consisting of the relatively steady net private saving plus government saving or dissaving, has therefore declined sharply since the low-deficit days of the 1950s and 1960s. The economy's total net investment (which differs from total net saving only by a fairly small statistical discrepancy) has, of course, declined in equal measure (see again Table 5). Because of a change from positive net foreign investment on balance before the mid 1970s to negative net foreign investment on balance thereafter, the deterioration of net domestic investment has been less severe than that of total net investment. Even so, net domestic investment has declined from 6.9% of gross national product on average during the 1960s to 6.2% on average during the 1970s, and only 3.0% thus far during the 1980s. All components of net domestic investment — business plant and equipment, residential construction, and business inventory accumulation — have shared in this decline.

In the context of this historical experience of the U.S. economy's balance of saving and investment, the implications of the current outlook for the U.S. Government deficit are clear enough. If the deficit remains in the range of 4-6% of gross national product, as now seems likely, it will absorb substantially in excess of half of the private sector's normal net saving. In the absence of a vast expansion in government saving at the state and local level, which appears highly improbable (indeed, the opposite is more likely), the federal government's deficit will therefore keep the U.S. net capital formation rate depressed throughout this period.

Once the economy returns to (or nearly to) full utilization of its resources, this problem will bear little resemblance to the decline in U.S. capital formation experienced during 1981-83. With ample unemployed resources available throughout the economy, and the budget nearly balanced on a full employment basis, it is implausible to suppose that the federal deficit was responsible for the low rate of capital formation during these years. The opposite is a better description, as weakness in the investment sector both fed upon and added to weakness elsewhere in the economy, and therefore caused tax revenues to fall and transfer payments to rise. Even larger deficits, representing an active fiscal response to the 1981-82 recession, would probably have led to more capital formation rather than less in the preponderance of industries in which inadequate product demand constituted the chief impediment to investment.

As the economy now recovers toward full employment, however, the situation will change. Fewer unemployed or underemployed resources will be available. Product demand will not be weak. The source of the budget deficit will be not economic slack but a fundamental imbalance between the government's expenditures and its revenues. In the absence of some break from historical experience that is now difficult to foresee, the continuation of large government deficits under these conditions will then constitute a substantial impediment to capital formation.

Why Deficits Matter: Public Versus Private Debt

An alternative way of considering the threat posed for U.S. capital formation by these prospective federal deficits is to focus on relationships involving the economy's stocks of assets and liabilities outstanding. The chief regularity that stands out in the U.S. economy in this regard is the close relationship of the total debt outstanding, issued by all U.S. borrowers other than financial intermediaries, to U.S. gross national product. The U.S. economy's total debt ratio has displayed essentially no trend, and only a limited amount of cyclical variation, throughout the post World War II period. More importantly for the purpose at hand, the stability of this relationship between outstanding debt and nonfinancial economic activity has not merely represented the stability of a sum of stable parts. Neither private sector debt nor government debt has borne a stable relationship over time to economic activity, but their total has.

The heavy solid line at the top of Figure 1 shows the total credit market indebtedness of all U.S. nonfinancial borrowers as of the end of each year since the Korean War, measured as percentages of fourth-quarter gross national product, as well as the corresponding total indebtedness as of midyear 1983, measured as a percentage of gross national product in the second quarter of the year. The lines below divide this total into the respective indebtedness of each of five specific borrowing sectors: the federal government, state and local governments, nonfinancial business corporations, other nonfinancial businesses, and households.

The strong stability of the total nonfinancial debt ratio stands out plainly in contrast to the variation of the individual sector components

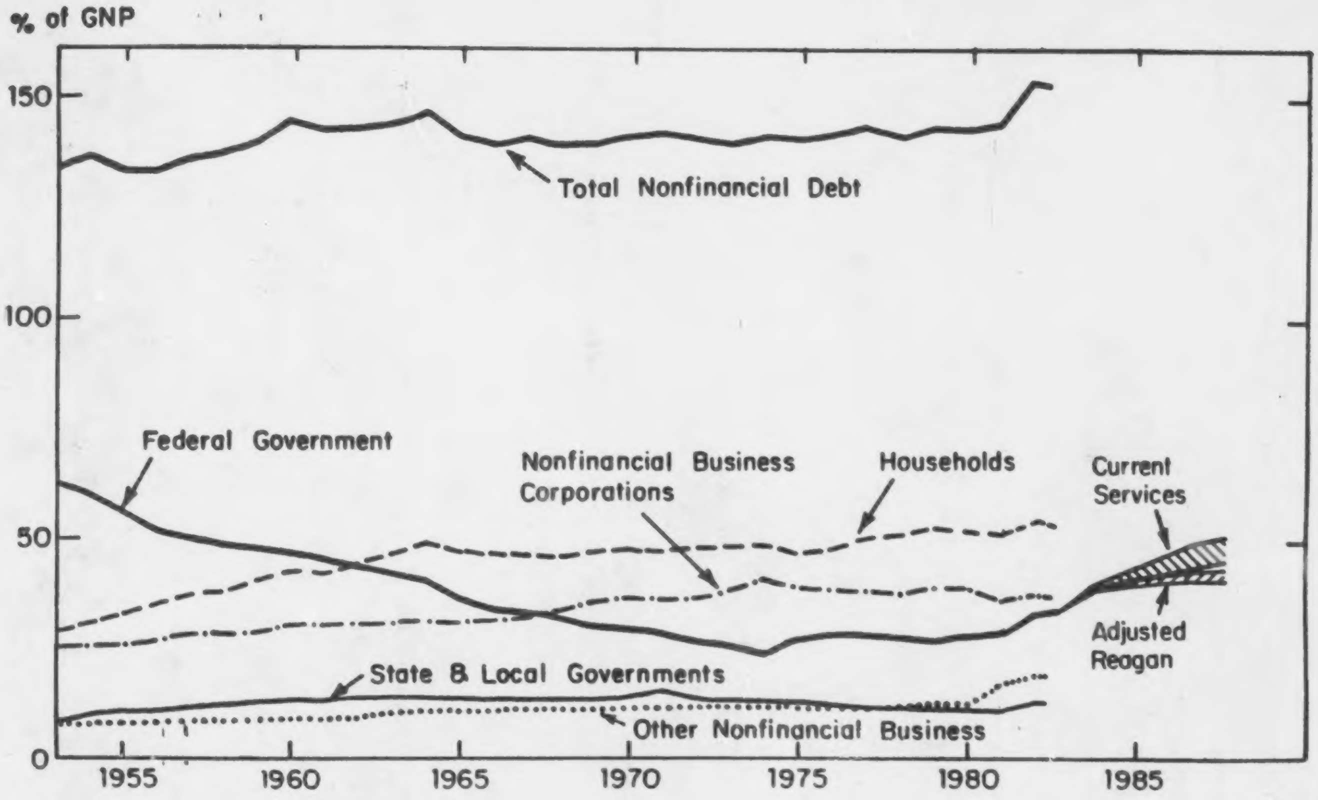

FIGURE 1

OUTSTANDING DEBT OF U.S. NONFINANCIAL BORROWERS shown below. Although the total debt ratio rose sharply during the most recent business recession, as gross national product in the denominator weakened while substantial credit expansion continued, data for the first half of 1983 already show the beginning of a return toward the historical norm of about $1.45 of debt for every $1 of gross national product. The experience of a similar, though less pronounced, cyclicality in prior recessions also suggests that the 1982 bulge does not represent an interruption of the basic long-run stability. Moreover, the stability of the U.S. economy's total debt ratio is of longer standing than the three decades plotted in Figure 1. With the exception of a sharp rise and subsequent fall during the depression of the early 1930s (when much of the debt on record had defaulted de facto), and to a lesser extent during World War II, the total debt ratio in the United States has been roughly constant since the early 1920s.

By contrast, the individual components of the total debt ratio have varied in diverging ways both secularly and cyclically. In brief, the post World War II secular rise in private debt has largely mirrored a substantial decline (relative to economic activity) in public debt, while cyclical bulges in public debt issuance have mostly had their counterpart in the abatement of private borrowing. Most importantly, except only for 1975-76 and 1980-83 — years marked by large deficits due to recession and its aftermath, as Tables 3 and 4 show — the federal government has reduced its debt ratio in every year to date since 1953, although this relative debt reduction has also been slower in years when even milder recessions have temporarily inflated the government's deficit.

Given the long-standing stability of the U.S. economy's total debt ratio, the evolution of the federal government's debt ratio provides a useful perspective on the magnitude and import of the federal budget deficit. During the post World War II period as a whole, the federal debt ratio has declined not just from 62.9% in 1953 but from 103.4% in 1946. Indeed, the 24-29% range in which the federal debt ratio fluctuated during the 1970s, and until 1982, corresponded favorably to the 27.4% value in 1918. The past decade has already marked an important departure from prior experience, however. The years 1975 and 1976 were the first since 1953 in which the government debt ratio rose, and the renewed decline during 1977-79, which was subsequently reversed by the recession years 1980-82, was not sufficient to reduce the ratio to its 1974 low. The government debt ratio rose still further during 1983, and current deficit projections indicated that it will continue to do so for the foreseeable future.

This increase in the federal government's debt ratio is relevant to the implications of fiscal policy for private capital formation because, in the context of a stable economy-wide total debt ratio, it represents a useful summary measure of the net impact of federal deficits on the environment for private financing. If the government deficit were sufficiently small, or if either real economic growth or price inflation were increasing the gross national product sufficiently rapidly, then the government debt ratio would be falling — as it was, almost continuously, throughout the first three decades following World War II. Conversely, when the deficit is sufficiently large in relation to the economy's size and growth, then the government debt ratio will be rising — as it was during 1975-76, and has been during 1980-83. Moreover, the nature of this stock-flow relationship is that, by comparing the nominal stock of outstanding government debt to the nominal gross national product, it implicitly allows not only for economic growth but also for the real capital gain that the government earns by inflating away its prior debt obligations. (An incidental, but also helpful, result of focusing on the government debt ratio measure is that it also readily illustrates the lack of fundamental importance to be attached to a precisely balanced government budget in a growing economy.)

If the economy's total outstanding debt remains approximately stable in relation to gross national product over time, then a sustained movement in the government debt ratio implies an offsetting movement in the aggregate debt ratio of the private sector. A falling government debt ratio like that experienced during 1946-74 implies a rising private debt ratio, while a rising government debt ratio like that during 1975-76 and 1980-83 implies a falling private debt ratio. The relevance in turn of a rising or falling private debt ratio for the economy's ability to undertake capital formation stems from the traditionally close connection in the United States between debt financing and net private investment, including both homebuilding and investment in new plant and equipment.

In the absence of a major change in financing patterns, therefore, the economy's ability to achieve a greater capital intensity — that is, to increase its capital stock in relation to total output — depends at least in part on the private sector's ability to increase its debt in relation to gross national product. Over time, however, the private sector's debt ratio moves inversely with the government debt ratio. In the end, the rise or fall of the government debt ratio is therefore likely to be an important factor shaping the relationship between growth of the capital stock and growth of the economy's total output.

The shaded extensions to the "Federal Government" line plotted in Figure 1 indicate the respective implications for the government debt ratio associated with several familiar projections of the U.S. Government deficit for 1984-88. Under the Administration's current services projection, the U.S. Government's outstanding debt will rise from 33.4% of gross national product as of midyear 1983 to between 44.5% and 51.0% at the end of fiscal year 1988. Under the budget proposals submitted by the Administration in February, "adjusted" only by removing the "contingency tax plan" which has lately received so much attention, the projected deficits imply increases in the government debt ratio to between 39.5% and 42.4% at the end of fiscal year 1988.

The main point of this set of comparisons is that the ranges for both the current services and the "adjusted Reagan" deficit projections will continue to carry the government debt ratio further upward, instead of returning it toward the 24.8% post-war low reached in 1974, or stabilizing it at the 1982 level of 30.1% or even the midyear 1983 level of 33.4%. These projected further increases will raise the government debt ratio to levels last experienced two decades or more ago — the early 1960s under the "adjusted Reagan" projection, or the 1950s under the current services projection.

A sustained increase in the government debt ratio of anything like these magnitudes will be unprecedented in the U.S. economy's post-war experience. If the economy's total debt ratio continues to remain near its historical norm, this increase in the government debt ratio therefore implies a comparably unprecedented decline in the private sector's debt ratio. As of midyear 1983, the debt ratios of the household and combined (corporate and unincorporated) nonfinancial business sectors were 53.2% and 53.0%, respectively — already down from 53.9% and 54.5%, respectively, at yearend 1982. A decline of 15-25%, applied either to households or businesses alone or to both together, will represent a substantial re-adjustment. The market forces (chiefly high real interest rates) which constrain the private sector to limit its debt expansion to a slower pace than that of nonfinancial economic activity — and not as a temporary retrenchment in recession, but on a sustained basis at full employment — will probably also affect private sector capital formation.

Although a renewed depression of residential construction could perhaps be sufficient to reduce household mortgage borrowing by enough to absorb the entire required decline in the private sector's debt ratio, especially under the smaller "adjusted Reagan" deficits, even that extreme outcome would probably not permit any growth at all in the business sector's debt ratio — nor would sacrificing homebuilding to such an extent be desirable anyway. More probably, business debt relative to income will also have to decline in order to make room for the ballooning federal government debt.

Without the ability to raise external funds in the credit market, the business sector will largely have to forego taking advantage of the recently legislated investment incentives unless it turns massively to equity financing — an unlikely prospect in light of long-standing U.S. business financing patterns. In terms of the factors directly confronting business investment decisions, the problem will be that the increased real cost of financing (and, for some companies, reduced availability) will outweigh the added attractiveness of new investment due to the large favorable tax changes. After the early stages of the current economic expansion, business net capital formation will probably begin to decline once again.

The conclusion of this analysis from the perspective of stock-flow relationships therefore matches the conclusion reached above on the basis of flow-flow relationships. In the absence of some break from historical patterns of economic behavior that is now difficult to foresee, the continuation of large government deficits now projected even for after the economy's return to full employment will constitute a substantial impediment to the U.S. economy's net capital formation.

Some Easy But Wrong Answers

When problems are as serious as this analysis indicates that the U.S. Government deficit problem will soon be, there are rarely any easy answers. If there were, they would already have been adopted and the problem would not be so serious after all. Nevertheless, hard problems that are resolvable only by hard policy choices almost inevitably elicit suggestions that no such tough choices are necessary, either because some easy solution is readily available or because the ordinary course of events will provide one on its own.

The threat to American business capital formation posed by the U.S. Government deficit in the 1980s is no exception in this regard. Three supposedly easy answers have dominated much of the public policy discussion of this issue to date. All are unsatisfactory.

Easy Answer #1 is that the lower tax rates legislated in the Economic Recovery Tax Act of 1981 will sufficiently stimulate personal saving to enable the economy to finance both enlarged government deficits and an increase in net capital formation.

Such an outcome is conceivable, of course, but it is unlikely for several reasons. To begin, a priori reasoning alone cannot even indicate the direction of the effect of higher after-tax returns on personal saving. The reason for this seemingly startling result is that higher after-tax yields affect the incentive to save in two potentially offsetting ways. Higher yields increase the reward, in terms of spending made possible later, for not spending today. This change in the terms on which consumers may substitute future for current spending increases the relative attraction of future spending, and hence unambiguously encourages saving out of current income. Higher yields also increase the rate at which savings grow, however, thereby making it possible to maintain desired spending levels in the future on the basis of less put aside today. This increase in lifetime total spending possibilities enables consumers to spend more both currently and in the future, and hence unambiguously discourages saving out of current income. Which of these two opposing effects is predominant can be determined only by resort to empirical evidence.

The problem here, however, is that the evidence on this question is ambiguous to say the least. Many important economic relationships have theoretically undetermined directions as well as magnitudes, but in the case of the effect of after-tax yields on saving the available evidence still provides essentially no ground for confidence about even the sign, much less the magnitude, of the net effect. Some studies have shown positive effects of a magnitude that would be meaningful in the context of the prospective deficit problem, while many others have shown no noticeable effect at all. At best, relying on a large saving response to the 1981 tax changes is hardly a prudent basis for sound public policy.

Further, despite the rhetoric that accompanied it, the 1981 tax bill contained few specifically targeted saving incentives. The reduction from 70% to 50% in the maximum marginal rate applicable to "unearned" income applies to relatively few taxpayers. The new IRA and expanded Keogh account provisions are potentially more important, but for many individuals they will only affect infra-marginal rather than marginal saving flows (and hence, by the reasoning outlined above, will unambiguously reduce those individuals' total saving). By far the greatest part of the personal tax reduction enacted in 1981 and implemented during 1981-83 has consisted of general across-the-board rate cuts, which are unlikely to have much impact on saving behavior even on the most optimistic rendering of the available evidence.

Finally, because the projected government deficits for the balance of the 1980s are so large, even a doubling of the personal saving rate — from the 1951-80 average of 4.8%, to 9.6% —, would merely finance the likely deficit, without leaving anything in addition to increase the economy's net capital formation. Only an extraordinary increase in personal saving, to magnitudes approximating that of several countries abroad, would meet both needs. Although the reasons why the U.S. personal saving rate is so low in comparison to that of some other countries remain imperfectly understood, they almost certainly involve some fairly fundamental aspects of societal arrangements rather than just marginal tax rates. Indeed, the simple cross-country correlation of growth rates and marginal tax rates is more often positive than negative (see Table 6).

Easy Answer #2 is that a combination of large profits during the economic expansion and the liberalized depreciation allowances legislated in 1981 will still provide business with a sufficient internal cash flow

TABLE 6

TAX RATES, ECONOMIC GROWTH, AND CAPITAL FORMATION

	Overall Effective Marginal Tax Rate on Corporate Sector Income	Average Growth of Real Capital Stock in the Corporate Sector	Average Growth of Real Gross Domestic Product
Germany	48.1%	5.1%	3.7%
United States	37.2	3.7	3.5
Sweden	35.6	4.7	3.2
United Kingdom	3.7	2.6	2.3

Notes: Growth rates are averages, per annum, for 1960-80.
Effective tax rates are based on average 1970-79 inflation rates.
Source: M.A. King and D. Fullerton, The Taxation of Income from Capital: A Comparative Study of the U.S., U.K., Sweden and West Germany — Comparisons of Effective Tax Rates. (National Bureau of Economic Research, 1983).

both to boost the historically small corporate saving rate and to enable business to undertake increased net capital formation despite the likely reduction in its relative indebtedness.

The problem here is that there is no one-for-one correspondence between increased business cash flow and increased net investment. At the most immediate level, the typical corporation is likely to pay out some fraction of the increased after-tax cash flow, either by raising dividends or by buying shares in other corporations in the course of mergers and acquisitions. There has already been some evidence of such activity, although corporate dividend payouts usually respond to changes in cash flows only with a lag.

Further, even that part of the increased cash flow which corporations retain still does not bear any direct correspondence to overall business investment. Net private saving in the United States is quite stable as a share of gross national product (see again Table 5). This relative constancy suggests that, on balance, respective fluctuations in corporate saving and in personal saving about offset one another, as shareholders adjust their own direct saving for the saving that corporations do in their behalf. More sophisticated statistical analysis confirms this result, typically indicating a personal saving response great enough to offset more than half of whatever variations occur in corporate saving. The basic point is that what constrains net private investment (apart from government and foreign deficits) is net private saving, and rearranging the composition of net private saving is not the same as raising its total.

A closely related line of reasoning is that, because price inflation raises the effective tax rate on business investment, the recent slowing of U.S. inflation will reinforce the effect of liberalized depreciation allowances and hence boost business cash flows (and after-tax rates of return) still further. In fact, however, recent studies have shown that the overall effective marginal tax rate on income generated in the U.S. corporate sector is relatively insensitive to inflation. Inflation clearly distorts the allocation of capital by widening the dispersion among the different marginal tax rates applicable to different forms of corporate sector investment. At the average inflation rate prevailing in the United States during 1970-79, for example, the range of marginal tax rates on income generated in the U.S. corporate sector extends from -105% (that is, a 105% subsidy) on machinery financed by sale of debt to pension funds and used in the commercial sector, to +111% (that is, more than full confiscation of proceeds) on buildings financed by sale of equity to households and used in commerce or industry. Nevertheless, inflation does not much affect the overall tax rate in a way that would plausibly reduce the total amount of capital formation.

Easy Answer #3 is that the United States can finance both its government deficit and its net capital formation with foreign capital inflows, as investors abroad increasingly see both high U.S. interest rates and the stable American political and economic environment as strong attractions for their saving.

Further increases in foreign capital inflows (corresponding to a negative net foreign investment position in Table 5) will no doubt occur. Indeed, for 1984 it is likely that such inflows will increase to 2% or more of U.S. gross national product — enough to finance one-half to one-third of the government deficit. Moreoever, such inflows do constitute a direct addition to the internally generated net saving available to finance both government deficits and private domestic investment. Why, then, are still further increases in foreign capital inflows not the most straightforward way to deal with the problem?

Especially in the context of concerns about the U.S. economy's international competitiveness, foreign capital inflows score points only by giving away the game. An inflow of capital from abroad is simply the mirror image of a balance of payments deficit on current account. Foreigners hold an increasing amount of dollar assets (net of U.S. holdings of foreign currency assets) because Americans are buying more from abroad than foreigners are buying from the United States. The resulting imbalance of payments on current account inevitably makes foreigners net investors in dollar assets and, correspondingly, inevitably produces a negative U.S. net investment flow.

The direct counterpart to these capital inflows, therefore, is exactly the deterioration in U.S. net exports which has produced such widespread concern about American business competitiveness in recent years. The U.S. balance of merchandise trade has deteriorated from a seemingly invincible surplus before 1971, to a mixed pattern of relatively small surpluses and deficits during 1971-76, to continual deficits of $25-35 billion per year during 1977-82, to a likely deficit of $60 billion in 1983. Because of a positive balance in services, together with substantial net investment income, the U.S. current account balance is typically more positive than the merchandise trade balance by $30-40 billion per year. A current account deficit equal to 2% of gross national product, or more than $60 billion, as is likely for 1984, therefore means merchandise imports in excess of exports by about $100 billion. In fact, the U.S. merchandise trade deficit will almost certainly set a new record again in 1984. Capital inflows and current account deficits in the range of 5% of gross national product, as would be necessary to finance the entire U.S. Government deficit during the remainder of the 1980s, would imply merchandise trade deficits of $250-300 billion per annum throughout this period — an enormous sum in comparison with the $250 billion of imports and only $217 billion of exports traded last year.

The chief market mechanism by which these large capital flows would have such devastating effects on U.S. net exports is the effect of real exchange rates on product demand and market share. If foreigners were willing to invest in the United States in such volume — and, just as improbably, if their governments were willing to permit it — their actions would further raise the international exchange value of the dollar after allowance for cross-country inflation differentials. The resulting higher real dollar exchange rate would in turn further erode the ability of U.S. exporters to compete in world markets, and a wide variety of other U.S. businesses to compete against foreign producers for domestic sales. In large part, this process has already accounted for much of the accelerated decline of U.S. competitiveness since 1980.

In addition, if a policy of large foreign capital inflows were maintained for very long, it would sharply change still further aspects of the U.S. economy's international economic balance, like the positive net flow of investment income. After all, borrowing from foreigners is fundamentally different from borrowing from ourselves. The United States' total net international investment position — that is, U.S. holdings abroad less foreign holdings here — officially stood at $200 billion as of yearend 1982. (After allowance for relevant "errors and omissions," the actual total was probably more like $100 billion.) Only a year or so of net capital inflow equal to the government deficit would entirely wipe out this net position, and subsequent inflows would increasingly make the United States a net debtor nation.

Solving the government deficit problem with foreign capital inflows would merely substitute a crowding out of the economy's foreign sector, via high real exchange rates, for the crowding out of the investment sector that would otherwise occur via high real interest rates. From the perspective of the economy's international competitiveness, that would hardly represent a satisfactory development.

In sum, none of these three "easy answers" represents an adequate response to the threat to American business capital formation posed by the U.S. Government deficit in the 1980s. A hard problem requires harder choices.

Tough Choices for Public Policy

What options are available, then, for preventing the U.S. Government deficit in the 1980s from having the adverse effect on business capital formation, and the economy's productivity and competitiveness, that is likely under a continuation of current tax and spending policies? The time has come — to be accurate, it is well past due — to search seriously for ways to reduce the deficit. To be successful, such an effort will probably require a willingness to compromise on other objectives also valued by important constituencies.

In terms of the balance of saving and investment, what is required is, at the least, to reduce the deficit to 2% of gross national product — in other words, some $84 billion on average during fiscal years 1984-88. Deficit reduction of that magnitude would at least restore the availability of net private saving as it stood in the 1970s. Alternatively, in terms of the outstanding stock of U.S. Government debt, returning the government debt ratio to its midyear 1983 level of 33.4% by the end of fiscal year 1988 would require shrinking the deficit to $118 billion on average during 1984-88, while returning the government debt ratio to an even 30.0% (the upper limit of its range during the 1970s) would require shrinking the deficit to $83 billion on average during this period. Either cutting the absorption of net private saving to its 1970s level or stabilizing the government debt ratio at the upper end of its 1970s range would therefore require very major changes, even in comparison with the Reagan Administration's budget proposals, not to mention currently existing tax and spending legislation. The important question is what changes.

The standard trio of suggested ways to reduce the federal deficit in the medium-run future includes cutting entitlement program benefits, slowing the scheduled acceleration in defense spending, and eliminating either the reduction in individual income tax rates which took effect in 1983 or the indexation of the tax code scheduled to take effect in 1985. The magnitude of the change involved in reducing the average 1984-88 deficit to the $84 billion level (or even $118 billion) is such, however, that no one among these three steps would by itself be sufficient. On the contrary, some combination involving major elements of all three is almost surely necessary.

Table 7 shows a decomposition of the U.S. Government budget position (including off-budget outlays) into components roughly corresponding to these three policy options, plus an additional expenditure category for net interest payments, measured throughout as percentages of gross national product. The table applies this decomposition to the actual outcomes for fiscal year 1970 (arbitrarily selected as a convenient benchmark), 1979 (the last in which the federal deficit did not exceed 2% of gross national product) and 1983, as well as to the projected average annual outcomes for 1984-88 on both the current services and the "adjusted Reagan" budget bases.

This decomposition shows that the substantial swelling of the U.S. Government deficit as a percentage of gross national product during the 1984-88 period reflects a combination of (1) a reduction in revenues of about 1% in comparison to either 1970 or 1979; (2) an increase in defense spending of about 2 1/2% in comparison to 1979, but not 1970; (3) an increase in net interest payments of about 1 1/2% in comparison to either 1970 or 1979; and (4) an increase in all other spending of about 4% in comparison to 1970, but not 1979. Such comparisons can never serve to resolve issues that depend so heavily on value judgments, of course, but they at least help to place in perspective the nature of the policy choices to be made.

Finally, difficult as it would be to reduce the federal deficit to $83-84 billion on average during 1984-88, even this magnitude of budgetary change would still provide not zero absorption of private saving and a falling government debt ratio, as in the earlier postwar decades, but

TABLE 7

COMPOSITION OF U.S. GOVERNMENT BUDGET AND BUDGET DEFICIT, 1970-1988

	Actual 1970	Actual 1979	Actual 1983	Projected 1984-88
Revenues				
Historical/Current Services	19.9%	19.7%	18.6%	18.6-18.8%
Adjusted Reagan Budget	-	-	-	19.2-19.4
Defense Expenditures				
Historical/Current Services	8.1	5.0	6.5	7.5-7.7
Adjusted Reagan Budget	-	-	-	7.5
Net Interest				
Historical/Current Services	1.5	1.8	2.7	3.0-3.3
Adjusted Reagan Budget	-	-	-	2.9
Other Expenditures				
Historical/Current Services	10.6	14.5	15.4	14.2-14.6
Adjusted Reagan Budget	-	-	-	13.4-13.6
Deficit				
Historical/Current Services	0.3	1.7	6.1	5.5-6.8
Adjusted Reagan Budget	-	-	-	4.4-4.8

Notes: Data are annual flows (for 1984-88 averages of annual flows), as percentages of annual gross national product.

Military retired pay is included in "other expenditures," not in defense expenditures.

Other expenditures include off-budget outlays.

Source: Office of Management and Budget, U.S. Department of the Treasury.

merely a 2% absorption of saving and a stable government debt ratio as in the 1970s — hardly an enviable era for federal budgets, corporate finance, net capital formation, productivity growth, and the U.S. economy's international competitiveness. Setting the stage for a restoration of the more favorable pre-1970 environment is almost certainly beyond reach in the foreseeable future.

* * *

Mr. Chairman, thank you for the opportunity to present my views to the committee.

Senator **Chiles**. I want you to elaborate your testimony a little bit on your one-third, one-third, one-third. You mentioned in your remarks, although I did not find it in your written statement, that approximately one-third of defense would be achieved by Chairman Domenici's proposed 5 percent figure.

We have some problems with that because you have got to try to determine whose numbers you are using. Normally, as you know, we use the CBO baseline in this committee. But we have the President saying the defense number in his budget is based on his own baseline, which is based on his own wish list, and not on CBO's baseline.

He takes those requests from a year ago and then says we are cutting defense by *x* number of dollars, but again he is cutting his own inflated request. The way I read the chairman's numbers, the 3-year savings amounts to $1.1 billion at the end of 3 years in outlays. We have to work off of outlays because that is where the deficit is affected.

So I am wondering how we get one-third of our savings if we are only saving $1.1 billion.

Perhaps it could be you are working off the President's numbers.

Dr. **Friedman**. Yes, sir, I am. As I understand it, the CBO baseline projection is based on a 5-percent real increase in defense spending.

TWO ANOMALIES EXIST IN FIGURES

Senator **Chiles**. I'm afraid we have a little anomaly there because the CBO baseline normally in every other area is the level at which programs were enacted the year before. For some reason for defense in CBO's baseline, they have the number approved by the Budget Committee last year, which was 5 percent, although if you look and see the programs that were enacted, it was closer to about 4.5 percent of what was actually appropriated. So we have anomaly No. 2.

I am trying to get all this so I can understand and compare apples to apples rather than apples to oranges when we are trying to make some savings.

Dr. **Friedman**. Yes, sir, what I had in mind was the comparison between the 5 percent real defense increase and the President's budget, not as submitted a year ago but as submitted this month.

My understanding is that when the President, for example, says he is saving $13 billion on defense in each of 1985 and 1986 fiscal years, he is comparing this year's proposals to the proposals that were submitted and rejected by Congress last year.

Senator **Chiles**. That is right.

Dr. **Friedman**. That is not what I was doing. What I was doing was comparing the 5-percent defense baseline, as in the CBO projections, with the budget that the President submitted this year.

Senator **Chiles**. Is that still not giving us some kind of a false saving because that is not the program? That is not the track we are on. That is not the path we are on. That is not even the deficit that is bothering us. That is something out there in the sky. While you say we are going to make a third of the savings off of that, the chairman's number only comes out to $1.1 billion. Yet you say we are going to take another third of the savings off of other domestic programs. Those are going to be real cuts, I assume, because you are not talking about pie in the sky there. You are talking about us cutting a third somewhere else.

I still do not know how our numbers are going to come out and give us the reductions that you are talking about of approximately $100 billion a year. That would sound great to me if we could get that, but I don't think you are using CBO estimates.

You are talking about what the President's wish list is.

Dr. **FRIEDMAN**. That is correct, Senator.

Senator **CHILES**. At least as I understand it.

Dr. **FRIEDMAN**. That is correct. I was assuming that by using the 5-percent real number, the CBO baseline already has built in what I was calling that third of the saving. Relative to that baseline, I was therefore not calling for any further saving.

PURSUE MORE EXPANSIONIST MONETARY POLICY

Senator **CHILES**. This is one of the problems we get into when we say defense is going to share part of the burden of savings. If it is from a wish list, then we should have had wish lists on our other domestic programs, and then they could share a bigger portion of the burden, too.

Dr. Cooper, in your testimony, you state that although high budget deficits do contribute to keeping the exchange rate high, a major factor is monetary policy and not fiscal policy.

You state that monetary policy was too tight for too long and it is still too tight. Are not both monetary policy and fiscal policy related? If the Fed's objective is to keep both interest rates and inflation rates at levels that promote reasonable growth, high Federal deficits make that almost impossible.

I am not trying to defend the chairman's policies, but it seems to me that with high deficits looming out into 1989 one cannot conduct a monetary policy that keeps both inflation and real interest rates low. Those high deficits would force us to either have a high inflation or a high interest rate or a combination of the two almost. Is that not correct? Or is there a way that we can have our cake and eat it too that way with these deficits?

Dr. **COOPER**. As Ben Friedman said, there are no easy solutions. If there were we would have introduced them a long time ago. And while I believe that the the most important proximate cause of the strong dollar is tight monetary policy, as I said in my statement, to say that is not the same as saying that there is an easy solution. If we were simply to pursue a more expansionist monetary policy, for precisely the reason that you mentioned, that given the way we have schooled ourselves and financial markets collectively over the last 10 years, a rapid increase in one or another measures of the money supply would indeed run the risk of rekindling inflationary expectations.

And of course that is compounded by the fact that we have a budget deficit that seems out of control. The two together, I think, put the Fed in a very delicate position. There is no question about it.

SHORT REAL INTEREST RATE OF ZERO APPROPRIATE

But I do believe that even though the Fed is in a difficult position, we still should call a spade a spade. The Fed has pursued a monetary policy that is extraordinarily tight for an economy in the condition that our economy has been in. And of course their tight monetary policy is one reason it has been in that condition. If you compare with any of the previous postwar recessions, real interest rates on Treasury bills, which is the lowest in the whole spectrum of securities that carry interest rates, real interest rates were approximately zero in all other previous postwar recessions, slightly negative, slightly positive, but near zero.

I would suggest that when an economy is running at high unemployment and low capacity utilization, a short-term real interest rate of approximately zero is appropriate, on the basis of the underlying economics of it. I emphasize short term. In spite of the appropriateness of a real short-term rate near zero, we have come through this recession with real interest rates on the order of 4, 4.5, and 5 percent—extraordinary by historical standards, even for periods other than recession. I believe that that is the cause of the strong dollar and indeed contributing to the depth of the recession.

Senator CHILES. None of you seem to have commented or made any kind of allowance or concern and I want to know whether you think it is or not for the fact that we have sort of deregulated the savings and we have a situation now in which the consumer is sort of very much into the savings market or able to buy. And we do know for years the saver sort of helped pay for the borrower. I mean, if you were a net borrower, you were much better off. If there was inflation you were paying back for those cheaper dollars and we had a very fixed savings rate in our Federal savings and loans.

What factor do you put or do you put any factor to that, the three of you, to the fact that we have now released that the usury laws are basically sort of out the window now and everybody is into the game of trying to get the highest price they can for their money.

Dr. Fischer, do you want to start off?

DEREGULATION HAS AFFECTED THE COST OF MORTGAGE BORROWING

Dr. FISCHER. Senator, I think that the deregulation has no doubt affected the cost of mortgage borrowing, which is——

Senator CHILES. That just seems to be a joker in the deck. We did not have that in some of these other recoveries.

Dr. FISCHER. Which is what you are referring to. I doubt that it would have the same effect on Treasury bill rates because once you have tied up the small saver in the savihgs and loans in the past and set that savings aside, you think you have less people going into the other markets. Now, you have freed them all up to go into Treasury bills or wherever the highest yields are.

So I think I do not have any doubt that you are quite right about mortgage rates which are very important in keeping housing relatively low in this recovery. But I do not think that would explain the Treasury bill rates to the same extent.

DEREGULATION HAS RAISED RATES ACROSS THE BOARD

Dr. **Friedman.** I think I disagree somewhat with Professor Fischer, Senator. My sense is that the deregulation of interest rates has raised rates more thoroughly across the board. Commercial banks, for example, now have to employ bought funds for something approaching half of their consumer deposits. This is a very large amount.

Banks now have super-NOW accounts and NOW accounts that are approaching half of their demand deposit balances. They have money market deposit accounts that are in the neighborhood of one-half of their saving deposits in noncertificate form. The certificates are also a large amount.

By deregulating the deposit market, we have forced all classes of depository institutions, including not just thrifts but also banks, to pay a higher cost of funds. That higher cost of funds makes its way not just to the mortgage market but also to short-term Government securities markets, for example, in which banks are fairly dominant participants.

We do not know enough to be able to quantify that increase. Some people may say that this is worth a half a percent. Some people may say it is worth 1.5 percent. We do not know. But the effect is broadly based, and it comes right through to the securities markets.

DEPRECIATION OF DOLLAR DRIVES PRICE LEVEL UP

Senator **Chiles.** Dr. Cooper, you mention that if the dollar starts to go, inflation would go up. Explain to me why that happens just as the dollar starts to go.

Dr. **Cooper.** I put inflation in quotes because I do not like the loose way in which we have come to use the term "inflation." What I really mean is the price level will rise. That is called inflation in common parlance.

If the dollar depreciates against the yen or the German mark, then although there may be some price adjustments on their side, in general the price of European and Japanese goods in the U.S. market will go up.

That then permits the price of American goods which are in direct competition with those goods also to go up, and if past experience is any guide, one would think that we would get a combination of things. Suppose the dollar were to depreciate by 10 percent against the mark. In the short run, the first 6 months or so, we would expect the dollar price of German goods to rise, but by less than 10 percent, and we would expect the price of American goods in competition with those German goods also to rise but by less than the price of German goods rises.

When you put it all together, the rough estimates are for every 10 percent change in the U.S. trade-weighted value of the dollar against other currencies, we would get a price increase of about 15 to 20 percent of that, that is, a 1.5 percent to 2 percentage points rise in U.S. prices, consequent upon a 10-percent change in the trade-weighted value of the dollar.

The reason is that the dollar price of foreign goods goes up and therefore the price of American goods, which are being depressed by foreign competition now, are released from that competition to some extent and those prices would go up.

Think of automobiles. When restrictions were put on Japanese automobiles in 1981, prices of American automobiles rose. If Japanese prices go up, American prices will also go up. That is the way the competitive system works, although perhaps not to the full amount.

So for those reasons, one would expect a decline in the dollar to have some price-level effects. Over a longer period of time, one might also expect commodity prices to adjust. The fact that oil prices were lowered from $34 a barrel for Saudi light crude to $29 a barrel in 1982 was not unrelated to the fact that the dollar appreciated during that time, so the price of oil in other currencies rose while the dollar price fell.

Under market pressures, the OPEC countries felt the need to reduce the dollar price of oil partly because the price of oil in other currencies had gone up.

By the same token, if the dollar were to depreciate, not in the next 12 months, but over a longer period, I would expect the dollar price of oil to rise. It happens that at the moment there is a lot of slack in the oil market, so that is not an immediate issue. But if one is talking about 1985 or 1986, we would see a response of oil prices to dollar depreciation, perhaps with a lag, and of course that would have an inflationary effect in this country as well.

IMPACT OF GOVERNMENT'S PREEMPTION OF NATURAL RESOURCES

Senator **Chiles**. Dr. Friedman, my staff tells me that you have done some interesting work and research on market or Government debt and the impact of Treasury obligations on interest rates, as well as the allocation of resources between consumption and investment. You have examined crowding out from the empirical viewpoint.

Given your previous research, what is your best guess on the impact of $200 billion to $300 billion deficits out to 1989 on the long run growth potential of the U.S. economy?

What is the short-run impact on the average household and their ability to buy a new home or a new automobile?

Dr. **Friedman**. Coming up with precise numerical estimates is difficult, Senator, but I will try to give you some flavor of what the results imply. The basic point is that the preemption of financial resources by the Federal Government leaves fewer financial resources for businesses to draw on in investing in plant and equipment or for households to draw on in building new homes. The real issue then becomes how much offset to that do we get from, for example, a higher saving rate, or from, increased foreign capital inflows.

In the decade of the seventies, for example, the economy's net private saving rate was on average 7 percent of GNP. The Government deficit at the Federal level was on average 2 percent of the GNP, but State and local governments on average ran a surplus of about 1 percent of the GNP. After taking away 2 percentage points for the Federal Government, and having the State and local government sector give back 1, we had about 6 percent of the GNP available for net investment. That amount was split roughly half-and-half between investment in plant and equipment and investment in housing. At that time the foreign sector did not particularly contribute.

If we now have a Federal Government deficit in the range of 6 percent of the GNP, and if the State-local government sector continues to run a surplus equal to, say, 1 percent of GNP, and if the saving rate continues to be 7 percent of GNP, there is left over only 2 percent plus whatever the foreign investors provide. Foreign investors will provide about 2 percent of the GNP in the form of capital inflows, unless some of the contingencies that my colleague, Professor Cooper, mentioned come about. There will therefore be something like 4 percent of the economy's GNP available for net investment in houses and in business plant and equipment.

My guess is that we will end up reducing housing more than we reduce business investment. My reason for saying that has to do with ACRS depreciation. We have, in effect, used ACRS to cushion some of the impact on the business sector. Instead of net capital formation by business being 3 percent of the economy on average as it was in the seventies, I would expect it to be perhaps 2.25 percent, which again is very, very low in comparison with any major foreign country, and also very low in comparison to our own past experience.

I would expect residential capital formation to fall from, say, 3 percent of GNP, where it has been in recent years, to less than 2 percent, as households have to face higher real interest rates in the mortgage market, without the advantages of being able to write off for tax purposes depreciation on houses. Hence households would suffer the same financial market disincentives through high interest rates that the businesses would, but without the depreciation offsets.

Senator CHILES. Senator Exon wants to ask some questions. I just want to say that I appreciate very much the appearance and the testimony of each of you. I think it is very helpful to us as we deliberate these issues. Senator Exon.

GAO'S DEFICIT FIGURES HIGHER THAN THE PRESIDENT'S

Senator EXON. Thank you, Mr. Acting Chairman. I have not been in a meeting with you for about 3 years where you have been chairman and it is kind of fun to be here again under these circumstances.

Gentlemen, thanks for coming. I have been listening with keen interest to what you have been saying in response to the questions by Senator Chiles. I want to add my thanks and appreciation for your coming here to give us your ideas.

Those of us who are here charged with decisionmaking in regard to the budget become seat-of-the-pants economists and we appreciate it very much when we have people of your expertise come here and tell us exactly what you think. We have been frustrated, I think, no end the last couple of weeks by administration witnesses coming before us, economists and noneconomists, saying directly contradictory things with regard to how the administration sees this problem. And we are trying the best we can to ferret it all out.

Let me ask you a few questions that come to mind and will be helpful to me as one member of the committee. I assume that you have seen the figures advanced to us by the President's budget wherein the President says that he predicts $180 billion deficit in 1985 and GAO has said, well, that should be $192 billion; 1986 the administration $177 billion, GAO $211 billion; 1987 administration $180 billion, GAO $223; 1988 administration $152 billion, GAO's estimate is $241 billion; and on into 1989 the administration has got their estimate down to $123 billion and GAO says no, it is just about twice that, $248 billion.

Now, and those figures I have given you are GAO estimates; in other words, the honest figures as they see the President's budgets. Now, given those differences that are of concern to us, of course, and I know that you are in a very inexact science, but likewise I look and I see the administration on their projections say that T-bill rates will drop between 1985 and 1989 from about 9 percent down to 5 percent or slightly under.

The administration says the inflation rate will go down from 4.5 percent to under 2 percent in 1989 and unemployment during the same period will drop from 8 to 6 percent. Now, I would just like to ask you what your view of those administration projections are and maybe we could separate, if we could, for brevity's sake, could I ask you if you think those are unrealistic, realistic or I do not know or any other amplication that you would care to make.

ADMINISTRATION'S ESTIMATES ARE UNREALISTIC

Dr. Friedman. The administration's estimates are unrealistic, for just the reasons that you said. We will have more price inflation in the course of the current economic expansion than the administration has suggested. In addition, we will have higher interest rates than the administration has projected. For the current fiscal year, in which the administration is projective a deficit of $184 billion and the CBO baseline projection is $190 billion, my calculations subject somewhere between $190 and $195 billion.

For fiscal year 1985 the President is projecting $180 billion, and the CBO baseline projection, adjusted to include the President's defense rather than the 5-percent real defense increase, is $216 billion. My projection for fiscal year 1985 is in the range of $200 to $210 billion. I was not able to carry my calculations out beyond the next 2 fiscal years. Because the President's budget assumes very unrealistic interest rates as we go out further, and probably unrealistic economic growth too, I believe that the CBO numbers are much more likely to be correct as we move into 1986 and 1987.

Senator Exon. Thank you.

BUDGET NUMBERS ARE CONDITIONAL ON LOWER DEFICITS

Dr. Fischer. Senator, I agree with what Professor Friedman said. I take it that your complaint about getting different stories from the administration was referring to disputes within the administration. My understanding is that Chairman Feldstein describes the budget as assuming that the deficit will be reduced through legislative action and that the budget numbers are conditional on your having taken or the Congress having taken action to get the deficits down.

Well, that action could be taken, so they are obviously actions that could make these numbers realistic, but it certainly is not anything approaching the current services budget. And in particular the number for inflation is extraordinarily low and extraordinarily optimistic.

Senator EXON. Dr. Cooper?

INTERNAL INCONSISTENCY IN FORWARD PROJECTIONS

Dr. COOPER. I also think that the figures are unrealistic. I hasten to add that I am not a forecaster. That is not my business. I take risks sometimes, but that is not one of the risks I usually take—except for very long-term forecasts, which are absolutely safe because nobody will remember them by the time we get there.

But I do note that the administration has for 5 years running a 4-percent rate of growth in the U.S. economy. Of course we achieved that in 1983 and in 1984 during the rapid recovery period.

But in order to support a 4-percent rate of growth over a larger period, given the demographic characteristics of the United States now which project a sharp decline in the rate of growth of the labor force, we would have to have a tremendous increase in labor productivity growth to levels which we have not seen in the postwar period except for a few years, apart from recovery years.

So I would say that while perhaps it is not technically impossible to have a 4-percent rate of growth 2 to 5 years from now, it is highly implausible. And given that it is highly implausible, the declining inflation rates that the administration projects at 4-percent rate of growth, also look implausible. A 4-percent rate of growth would mean driving unemployment down to much lower levels than they show and that in turn would result in higher rates of inflation, I think.

So I detect an internal inconsistency in their forward projections even without reference to the budget deficit.

Senator EXON. Is it safe to say then that—let me phrase it this way. Do you agree then that there is a likelihood at least that we will fall back on the historic method of governments paying for deficits and that is through inflation?

Dr. COOPER. Are you asking for an unconditional forecast now?

HISTORICAL RECORD NOT ALL ONE SIDED

Senator EXON. No. I am asking this question: Is it not true that in economic history governments have paid off skyrocketing debt through inflation? Is that not the usual way for governments to tackle the matter of high deficits and debt?

Dr. COOPER. If you count heads, I am sure the answer to that is yes. There are many countries that in fact have covered budget deficits through inflation and through that mechanism have eroded the value of outstanding local currency debts to some extent, although usually those countries run into trouble after a few years and have to pay much higher interest rates.

There are however some striking counterexamples where governments have not paid off their debts by inflation, including one in the United States just 100 years ago in the 1870's, where we managed the economy in such a way that gold parity of the inflated greenbacks was restored.

So the historical record is not all one sided.

Senator **Exon**. How about the—that was in the days of yesteryear, so to speak.

Dr. **Cooper**. That is what we were talking about, historical——

Senator **Exon**. What about in this century? Have there been examples where—I am thinking, you know, of World War II, Germany, in modern day economics, which I will define for the sake of discussion, this century, has it not been customary for governments to use inflation to pay off debt for the most part?

Dr. **Cooper**. Curiously enough, although I would not want to cite the period as a positive example for anything else, during the 1930's a number of Latin American countries deflated their economies enormously in order to continue paying their external debt.

Senator **Exon**. I see.

Dr. **Cooper**. Some of them did not succeed in the end. Some of them actually did succeed. Now, that was external debt, not internal debt. But there are examples of that. Finland for years ran a very conservative economic policy in order to pay off its World War I debt. So there are examples in this century. But again, they do not make up the majority.

Senator **Exon**. Dr. Fischer?

Dr. **Fischer**. Senator, actually in the United States even after World War I we did not pay off that debt by inflating but we had a very severe contraction, which brought prices down by about 50 percent in 1921. So even then we did not do it. But after World War II prices did rise, I guess, more than they had been expected to rise when the debt was floated. So we did that then and I think in this era since we have gotten away from gold as a monetary anchor what you are saying is broadly right.

But what you are asking us to do is to forecast whether Paul Volcker is going to hang tough and who Paul Volcker's successor would be. My own guess is that for at least a few years the dislike of inflation that became very evident in the late 1970's is going to keep the lid on inflationary methods of handling the debt.

If the burden then becomes very large, I guess people will rethink whether they really dislike inflation that much.

Senator **Exon**. In that regard, I had a farmer tell me within the last couple of weeks, Senator, you know, you do not know how much better off I was when I paid 19 percent interest and inflation was at 12 percent. I was a whole lot better off than I am today. So you run into all these kinds of things.

Thank you.

WE DO HAVE CONTROL OF OUR ECONOMIC DESTINIES

Dr. **Friedman**. Senator, I am quite sympathetic to what you are saying about the likely pressures to monetize the debt and thereby create inflation. It would be unfortunate, though, to regard that process as inevitable. There are some aspects of our economic destinies over which we seem to have more control than others. In talking not about the inflation rate in 1984 and 1985, but the longrun inflation trend, I would be very discouraged to think that somehow we had moved monetary policy and longrun inflation trends into that realm of our economic future over which we have to be resigned to unfortunate outcomes. Stanley Fischer was exactly right.

There is a specific decisionmaking body, the Federal Reserve System, which decides on these issues. That decisionmaking body or is responsible, under the law, to the oversight of the Congress. To throw up our hands, and say that there is nothing that anybody can do about that, is giving away much too much. To the extent that there is a danger that we will go back to an accelerating inflation trend, we should exercise more vigilance, and the Congress, through its responsibilities for overseeing the Federal Reserve, should be more vigilant. To the extent that we recognize that pressures for monetizing the debt will result from the current fiscal policy, which we seem less able to do something about, we should be all the more vigilant.

I would be very reluctant to abandon the idea of monetary policy and longrun inflation trends being an area of economic outcomes that we can in fact do something about.

Senator **Exon**. I would agree with you. As we look forward to growth, which we think we need and you have all more or less questioned the likelihood of 4 percent or more annual growth that the administration has forecast, what is your idea of the main reasons or the main reason, if we can, for the economic recovery that now is supposedly taking place.

I can assure you it is not taking place in agriculture. It is one of those industries that essentially has been left out and left behind and is in deep, deep trouble.

But what do you think are the main ingredients of the economic recovery that is now taking place? I view that the main reasons probably are the fact that we have infused the economy like we have never infused it before in more than one area. Generally speaking, the good times have rolled in America when we go into extensive deficit financing and therefore pump money into the economy.

Likewise, the good times usually rolled in America when we had massive tax cuts. Third, the good times usually roll in America or shortly thereafter when we go on a wartime economy.

Now, it seems to me that in the last 2 years at least we have done all three of those, which leads me to believe that maybe those are the major reasons for the economic recovery. And I suspect that we are not going to be able to continue those juices to the economy in the future. What is your reaction to that statement?

ECONOMY CREATED WITH KEYNESIAN ECONOMICS

Dr. **Friedman**. I agree with you, Senator. We have had a significant economic recovery within the past 15 months. It has been an almost stereotypically Keynesian recovery, led by Government spending and private consumption and a few interest-sensitive areas of the economy.

The policies that are in place were supposed to give us a recovery led by saving and investment. Saving and investment are not up; they are down, and noticeably so. I was commenting before you joined us that 1983 was the worst year in post World War II U.S. history for net business capital formation. That is hardly a positive response to anything. The personal saving rate is not up; it is down. It was at a record low last year. We are not yet seeing a recovery led by saving and investment.

Instead, consumer spending was up across the board. That was one major element. A second was that Federal defense spending was up 11 percent last year. And a third element was that, with the decline in interest rates we got a very large increase in interest-sensitive areas of economic activity like housing, which was up 44 percent last year, and auto sales, which were up 21 percent. That is where our economic recovery has come from.

It is a typically Keynesian recovery, which came out of some very typically Keynesian policies disguised under other names.

Senator Exon. Dr. Friedman, I am going to give you a chance to correct the record if you want to. Are you testifying here that this highly conservative, free enterprise administration has created an economy with Keynesian economics which has been the antithesis to that thinking as long back as I can remember? Is that what you are testifying to?

Dr. Friedman. Yes, sir.

Senator Exon. Thank you. Dr. Fischer.

Dr. Fischer. Well, Senator, that is of course quite right. It is almost ironic now to read the newspapers and see people who are devoted supply siders making arguments which are indistinguishable from Keynesian arguments, blaming the Fed for our unemployment in saying that everything would have been fine if we had a different monetary policy.

I think the point you make is extremely important. We come out of this recession with very straightforward aggregate demand expanding measures and that is why output has risen. The deficits that we have had in the last few years were a major beneficial impact on the economy in getting us out of the recession that we were put into as part of the anti-inflation policy.

Now I think is the time when we have to actually start thinking seriously about how the growth policy will continue, and that is why investment now becomes particularly important. Typically in a recovery, in the second year of the recovery, there is a shift from the components of demand that Professor Friedman mentioned, housing, automobiles, that sort of thing, to business investment. That is the component that we are in danger of not having unless the deficits are taken care of now. And it is now that the crowding out of investment will become particularly important.

So now is the time that the deficits have to start being brought under control to enable us to invest and to produce the larger output that we hope for the years ahead.

Senator Exon. Thank you, Dr. Fischer. Dr. Cooper?

Dr. Cooper. I agree with both Dr. Friedman and Dr. Fischer. I observed already in 1981 that if a man from Mars came and did not understand spoken English and therefore did not hear any of the speeches that were made but just read the legislation, he would describe the 1981 tax cut as a Keynesian measure, basically an across-the-board tax cut with a few wrinkles here and there.

The core of it, the body of it, as Dr. Friedman said earlier, was an across-the-board tax cut.

Senator **Exon**. Gentlemen, with that I want to thank you very much for being here. You have been very helpful and informative. And with that, we are adjourned.

[Whereupon, at 4:05 p.m., the committee was adjourned.]

WRITTEN COMMITTEE QUESTIONS TO WITNESSES AND THE RESPONSES

QUESTIONS TO MR. STOCKMAN

ACID PRECIPITATION RESEARCH PROGRAM

Question

What are the current and projected estimates for budget authority and outlay levels for this research, demonstration, and development program?

Answer

Funding:		83	84	Supp.	84-85 Approp. % Inc.	85	86	87	88
Research									
Interagency T.F.	BA	22.3	27.6	(5.5)	100	55.5	55.5	55.5	55.5
	BO	14.5	20.6	(1.1)		32.9	45.7	52.3	55.5
Control Technology & Other									
EPA Control Tech.	BA	3.7	9.8	--	0	9.9	0	0	0
	BO	5.1	6.0	--		7.9	7.0	3.7	1.4
DOE Control Tech.	BA	48.3	36.6	--	55	56.6	55.9	42.4	43.9
	BO	52.3	35.1	--		51.5	54.9	48.5	43.7
DOI Liming Program	BA	0	0	--	N/A	5.0	0	0	0
	BO	0	0	--		3.0	2.0	0	0
Total	BA	74.3	74.0	(5.5)		127.0	111.4	97.9	99.4
	BO	71.9	61.7	(1.1)		95.3	109.6	104.5	100.6

Budget Proposal:

- A $5.5M supplemental appropriation in 1984 for a comprehensive survey of acidified lakes. $55.5M in 1985 for the Interagency Task Force on Acid Precipitation, a 100% increase over the President's 1984 Budget.
- $66.5M (a 43% increase over 1984) in 1985 for the development of cheaper and more effective acid rain control technologies. Includes joint Federal private sector demonstration of the Limestone Injection Multistage Burner (LIMB).
- $5M in 1985 for a remedial action program in the Fish and Wildlife Service to implement a liming program in cooperation with affected states to restore and restock acidified lakes.

Question

2. Will the Administration propose an acid rain to control program in 1984?

3. Does the Administration plan on proposing an acid rain control program in the future? If so, what will it cost the federal government? How will it be funded?

Answer

As Administrator Ruckelshaus indicated in testimony before the Senate Environment and Public Works Committee, the Administration is not prepared to recommend additional sulfur dioxide controls based upon current scientific information. However, if conclusive evidence becomes available indicating that significant aquatic or terrestrial damages are occurring as the result of acid rain and that mandatory pollution controls would be effective in reducing these effects, we would certainly reconsider this position.

INTEREST RATE DECLINE

QUESTION

On page 2-4 of the Budget you present two tables comparing inflation rates between 1980 and 1983 and comparing interest rates between those same years.

Your table shows inflation as measured both by the GNP Deflator and the CPI. And it shows rates for 91-day Treasury bills; the Prime Rate; and a Mortgage Rate.

In the accompanying text you say: "This moderation of inflation was accompanied by a sharp drop in interest rates as inflationary expectations declined."

Yet your tables show that real interest rates, using either measure of inflation, have risen, not declined. Why have real interest rates not declined with the lowering of "inflationary expectations?" Could it be because of high deficits?

	REAL INTEREST USING	
Interest Rate Measure	GNP Deflator	CPI
91 Day Treasury Bill		
1980	3.4%	1.0%
1983	4.7	5.9
Prime Rate		
1980	6.5	4.1
1983	6.9	8.1
Mortgage Rate		
1980	4.1	1.7
1983	9.4	10.6

ANSWER

During the 1980-83 period, the decline in the rate of inflation was accompanied by a drop in the nominal rate of interest. However, the 'real' interest rate (or the nominal rate corrected for inflation) has risen over that same period. This increase in real interest rates is typical of historical experience with monetary disinflation: it takes time for reduced expectations of inflation to be reflected in reduced nominal interest rates.

The real interest rate equilibrates the supply of saving, both private and public, to the demand for savings, in the form of investment. The real interest rate will rise either if the supply of saving shifts down or if investment shifts up. The supply of saving has shifted down recently. Private savings has declined due to the recession and public saving has declined as evidenced by the deficit.

Although the decline in savings is the most widely cited explanation for high real interest rates, another explanation is uncertainty due to increased variability in the money supply. This makes nominal dollar assets less attractive, so they must yield a higher expected real return as a 'risk premium'.

In order to bring down the nominal interest rate from present levels, two separate tactics are necessary: reduce the rate of inflation in order to bring down expectations of inflation, and bring down or prevent a rise in the basic or real rate of interest. As it happens, these are influenced by separate yet correlated factors. Large government deficits financed by increased borrowing will push up the basic rate. On the other hand, large increases in the money stock will increase anticipations of inflation. The ability to control the money stock to avoid inflation and its anticipation is not entirely divorced from the size of the deficit that is financed by borrowing.

LINE ITEM VETO

QUESTION

In the past 3 years, the President has told us he wanted Congress to adopt a constitutional amendment to mandate a balanced budget. He said that, even though he was unwilling to suggest how the budget could be balanced.

Now the President is asking for a line item veto -- again to reduce spending and deficits. But I have not heard him say how he would use it.

Can you suggest to us some past occasions when the President could have used a line item veto to reduce spending and how much these vetos would have reduced federal spending?

ANSWER

The specific applications of authority provided by a line-item veto amendment will depend in the first instance upon the nature of the authority that is granted, which cannot be know now. It will also vary greatly depending on the conditions that prevail at the time decisions are made. Past conditions cannot be replicated accurately, and the future conditions that might prevail are not known. It would thus be fruitless to speculate on the specific ways in which such authority might have affected the budget in the past.

INTEREST ON THE PUBLIC DEBT

QUESTION

In the Budget in Brief (page 19) there is a section titled, "Reordering the Nation's fiscal priorities."

This section begins: "Vast changes in the Federal budget's structure occur over time. The re-direction of policy inaugurated by the Reagan administration is such a change."

A little further on, the section states: "The fiscal course charted by the administration for the 1980's essentially seeks a restoration of the 1971 status quo ante."

The Budget itself says, in this same regard: "...the minimization of potential future tax increases will require additional steps to lower domestic spending below the 1989 goal.... now embodied in the proposed budget."

It them goes on: "Given the pending solvency crisis in medicare, excessive annuity levels embodied in Federal pensions, and the potential for further reform of benefit indexing mechanisms, it is apparent that opportunities for such savings exists."

First let me say that the Reagan administration's "reordering of priorities" seems to lean heavily in favor of paying more in interest payments and less in productive program activity. Looking back to 1971, interest payments were $19.6 billion, about 1.4% of GNP. By 1989, the Administration proposes $126.3 billion, or 2.4% of GNP.

So you are saving that we should cut Medicare, cut federal military and civilian pensions, and cut Social Security and other COLAs to avoid tax increases -- when we could have acted to hold down deficits over the past several years and created savings in interest payments.

ANSWER

The Federal government is required by law to honor its just debts. This fiscal responsibility will cause hard choices to be made when allocating remaining available funds among federal spending programs. Thus, if there are any savings that can be achieved in current programmatic spending, they should be put into effect prior to increasing the tax burden on the productive sectors of the economy.

There is no one-for-one swap made between interest outlays and COLA costs to the Federal government contained within the 1985 Budget. The growth in most programs is being held constant in real terms due to the re-direction of policy inaugurated by the administration. Potential problems still exist such as the impending solvency crisis in Medicare and the excessive annuity levels in Federal pensions. When benefit indexing mechanisms cause outlays to exceed inflows for indexed programs, the fiscal imbalances that result cause major disruptions in the process of financing other spending programs.

The effort to reduce the deficit and thus interest costs should focus first on outlay savings within existing programs and, when all of those savings are achieved, other means for reducing the deficit should be explored.

QUESTIONS TO MR. MOTLEY

BUDGET FREEZE TRUCE

Question 1. I have suggested to each of the Administration witnesses that what we need is a Truce to allow all sides here in Congress to discuss how to make at least a Down Payment on the deficits this year. I think it would be important to include interested private groups in that Truce and those discussions as well. Do you agree with that approach?

Answer. In general, we would agree that a truce in the form of a general freeze on spending and taxes should be enacted, for several reasons. A political truce may allow time for all parties to sift through the rhetoric and to clearly understand the scope of the budgetary problems we are facing and the limitations which proposed solutions provide.

A truce in the form of a budget freeze would hurt no one group more than another while at the same time would allow the opportunity for analysis of the various budget programs when placed in a no growth mode.

Inclusion of private groups into the budget negotiations could be helpful to the members if all parties understood and agreed with the same goals of such an effort.

DOWNPAYMENT NEGOTIATIONS

Question 2. If we are going to negotiate a Down Payment, what elements of the budget do you think must be included? Defense? Taxes? entitlements? Discretionary, appropriated programs?

Answer. When negotiating a down payment on the deficit, all spending programs should be equally impacted but specifically the growth in cost-of-living allowances provided for in non-means tested entitlement programs need to be reviewed. Taxes need to be examined within the same context of an across-the-board review.

CANDIDATES FOR BUDGET REDUCTIONS

Question 3. Can you suggest areas of concern to the groups that you represent that might be candidates for budget reductions?

Answer. We have no policy to recommend budget reductions in any specific program. Our membership has repeatedly expressed their belief that percentage reductions in all programs to desired levels is the fairest way to approach the problem of reducing spending, and we have previously stated that programs within the Small Business Administration should be reduced in that context.

DEFICITS AND INTEREST RATES

Question 4. The President has said in his budget that he believes the deficits will fall from about $180 billion to about $123 billion in fiscal year 1989? This depends, of course, on continued real growth in GNP of about 4 percent each year. It also depends on Treasury Bill rates falling to about 5 percent. There are others who think that, under the President's budget, deficits may well climb to over $250 billion unless further spending cuts and revenue increases are found. Do you believe that, under the President's budget, deficits and interest rates are likely to fall over the next 5 years and that real economic growth will continue strong?

Answer. The ability of the economy to continue its expansion over the rest of the decade is predicated on a favorable economic climate which must necessarily include favorable real rates of interest. To the extent that projected budget deficits remain in the $200 billion range as has been projected, interest rates will likely remain high. The result of high real rates of interest will be a lower level of economic growth than is currently anticipated under the President's budget proposals and continued imbalance in the budget.

The revised budget proposal supported by the President in the Senate is better as far as it goes, but failure to enact changes in cost-of-living allowances in certain entitlement programs hurts chances for real budget savings.

REAL INTEREST RATES

Question 5. Over the past year, nominal interest rates have fallen substantially. But most *real* interest rates, whether the Treasury Bill rates, the Prime rate, or mortgage rates, have actually increased as inflation has fallen. Why do you think real interest rates have remained high? What will it take to bring them down? How important is it to housing and to business that they come down?

Answer. There is no one reason why real interest rates have remained so high, but certainly fear of inflation and fear of high interest rates fueled by a large and growing deficit are among the likely culprits. In addition, due to our recent economic history, most investors are reluctant to make long-term commitments without adequate rates of return.

Obviously confidence in the financial markets is a key component to reducing interest rates, and such confidence can only come about when inflationary expectations and budget deficit fears are reduced.

Housing markets are extremely sensitive to changes in interest rates, as the rate of interest directly impacts on a family's ability to afford a house. Small business is strongly tied into the housing market from various sectors and benefits greatly from a strong housing market. A significant increase in interest rates would have the effect of hurting the housing market and consequently will have an impact on small businesses.

HOUSING

Question 6. What is the outlook for housing in 1984 and 1985? Will new starts stay around 1.7 million? Will housing help to sustain the recovery? Or will a strong recovery from other sources be necessary to sustain housing?

Answer. A strong housing market is a definite plus to sustaining a recovery, but the housing market cannot possibly sustain the economic recovery on its own. Certainly all other major sectors of the economy must be brought into play in sustaining an economic recovery.

MORTGAGE REVENUE BOND PROGRAM

Question 7. One very important housing program in Delaware is the mortgage revenue bond program. It has been important around the country as well. As you know, that program has expired, despite the efforts of many of us to reenact it. If this program is not renewed, what do you believe will be the national impact on the availability of housing for lower income, first time homebuyers?

Answer. No policy.

HOUSING SUPPLY

Question 8. Is there an adequate supply of standard housing for lower income persons in this country today? If we gave housing vouchers to them, could they find the housing? Or do we need programs to stimulate new construction to assure an adequate housing supply?

Answer. No policy.

BALANCED BUDGET AND LINE ITEM VETO AMENDMENTS

Question 9. The President has recommended that there be two constitutional amendments: one to provide for a balanced budget and restrained spending; the other to give the President a line item veto. Yet there is no real evidence as to how he would use either one, were it to be effective promptly. Do you support such amendments? Do you have specific language or provisions that you recommend? In what ways do you believe that such amendments would be useful in dealing with the kind of $200 billion deficits that the Federal government is running?

Answer. NFIB members support both a balanced budget amendment and the proposal for line item veto.

The proposal for a mandated balanced federal budget is at the heart an expression that Congress be held accountable to spend no more than it takes in. When Congress runs a deficit, the effects are inflation and unstable interest rates. Small business owners are strongly convinced that they bear the greatest burden from economic policies that allow inflation and high interest rates to occur.

A Presidential line item veto would prevent the need for a veto of a whole appropriations bill because of disagreement on one specific item in a budget. This approach just seems practical as appropriations bills become more and more complex.

QUESTIONS TO DR. PENNER

ECONOMIC ASSUMPTIONS

Question. I'm curious about your economic assumptions. I understand your assumptions for real GNP, and its relation to inflation and unemployment are, as you say, "broadly consistent with historical experience."

Then I look at your "low-growth" scenario. It, too, is broadly consistent with historical experience. It shows an average 3 percent growth rate over the next five years, with a mild recession in 1986.

Yet the difference between the two scenarios is $65 billion in the 1989 deficit. That's quite a substantial difference.

My question is this: If we all abdicate this year, would we be putting in train now forces that will make a $400 billion deficit by 1989 more likely?

Answer. Our economic forecast through 1985 takes into account the very large projected deficits, but the longer-term economic projections for 1986–1989 are not necessarily consistent with current fiscal policy. They are based on historical trends, and are intended to be a reasonable benchmark for decisions about budget policy. The alternative economic scenarios presented in our reports including the $400 billion deficit based on our low-growth scenario, illustrate the extent of uncertainty about the budget deficit that would result from a continuation of current policy.

The effect of continuing current fiscal policy is to reduce investment and economic growth in the long run, and therefore, to produce even larger deficits with given tax rates and spending policies. The point at which this happens can be delayed by borrowing from abroad to finance the deficit, but only at the cost of paying larger and larger proportions of domestic production to service the debt to foreigners. And in the absence of action to resolve the inconsistencies of fiscal policy, there is a serious probability that foreigners will cease to lend to the United States. Whether it will happen in the next five years is more than I can say, but it must happen eventually.

However, in the short run—which I interpret as a period of about two years—there is much more uncertainty about the effects of large deficits on the economy and the tax base. For this reason, it is much more important that policies be put in place that will clearly reduce the deficit in the long run, than that the actual deficit be reduced in the next year. I believe the costs of delay in putting into place such long-run policies are to be found in the increased uncertainty felt by businessmen and consumers as to how the deficit problem will ultimately be resolved, an uncertainty that will translate into unwillingness to make long-term plans and investments.

COMPARISON OF CBO'S 5-YEAR ECONOMIC PROJECTIONS

Question. I wonder if you could provide for me, and for this committee, a comparison of CBO's 5-year economic projections, since they were begun, to what has actually occurred. And I wonder if you could also do the same type of analysis for CBO's projections of the long-term consequences of each year's budget resolutions in terms of revenues, outlays, deficits, tax expenditures, unemployment, real GNP, outlays as a percentage of GNP, inflation and interest rates.

Answer. The attached tables provide information on successive five-year projections of key economic indicators of the economy as well as estimates of current policy receipts, outlays, and tax expenditures consistent with CBO baseline estimates. For each variable, the left-hand stub indicates when each five year projection was prepared, and the years across the top of each table mark the years for which each projection was made.

These represent what the CBO provided to the Congress as estimates of current policy prior to the Congressional debate on the first budget resolution. The economic assumptions of the first budget resolution often differed somewhat from CBO's, and quite often included changes in fiscal policy. These policies were not always reflected in subsequent legislation.

The estimates are, of course, not strictly comparable over time:

The thrust of both fiscal and monetary policy in the outyears was unknown at the time these projections were made.

The economic projections for the outyears have never been considered actual forecasts of the most likely outcome, given present policies. Indeed, their motivations have changed over time.

Current policy estimates of receipts and expenditures are often quite different one year later because of changes in legislation.

The conceptual basis of tax expenditures changes over time.

Economic Projections (See Table 1, in six parts).—The first two years of each projection is a forecast, conditional on the budget policies in the CBO baseline. This forecast cannot be simply compared with the outturn, for two reasons:

Fiscal policy was changed from the CBO baseline during the budget process. CBO could not predict these changes, though some private forecasters attempt to do so.

The forecast was prepared assuming that the data available on the economy at the time were correct. Subsequent revisions, particularly in the level of nominal GNP, are usually significant for the short-term forecast.

Until early in this decade, the longer-run economic projections were the result of an informal process of goal setting. That is, the staff of the Budget committees would decide on a path of the economy that represented what the Congress might adopt as a set of policy goals if it were to engage in such an exercise. CBO provided technical analysis to ensure that the various economic measures were consistent. However, the current policy budget estimates were usually not consistent with the economic baseline. Largely because of progressivity in them tax code, the budget always moved into surplus in these kinds of calculations, even though it was widely recognized that taxes would have to be reduced by the Congress several times over the period if the projected economic growth were actually to be realized. This inherent contradiction was pointed out by a number of analysts, and qualitative estimates of the required amounts of additional fiscal stimulus were provided by the CBO via its "closing the loop" analysis.

Criticism of this approach mounted, however, and the poor economic performance since 1979, coupled with the multiple-year tax policies put in place in 1981, prompted the CBO to move toward more "realistic" projections of economic performance. Most recently, the CBO has developed five-year projections that are consistent with historical trends. In our most recent set of projections, for example, growth over the seven-year period consisting of the forecast and the five-year projection averages 4.0 percent, which is the average of seven recoveries since the Second World War.[1]

These events have led to a complete reversal of the earlier situation: instead of showing budget surpluses in the outyears, we now project large deficits. However, most analysts believe that the large federal government deficits threaten economic vitality and that, without substantial changes in current policies, the five-year projections would not be realized.

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[1] For a detailed explanation of this projection, see, The Economic Outlook, CBO Report, February 1984, pp. 7-18.

TABLE 1.1 NOMINAL GNP (Billions of dollars)

	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Actual	1718	1918	2164	2418	2632	2954	3073	3311						
1976 Forecast a/	1675	1845	2050	2270	2500	2755								
1977 Forecast b/		1885	2085	2304	2547	2809	3103							
1978 Forecast c/			2107	2334	2582	2854	3156	3465						
1979 Forecast d/				2351	2595	2894	3229	3595	3989					
1980 Forecast e/					2555	2849	3210	3611	4050	4529				
1981 Forecast f/						--	--	--	--	--	--			
1982 Forecast g/							3140	3515	3882	4259	4659	5083		
1983 Forecast h/								3266	3580	3903	4221	4540	4878	
1984 Forecast i/									3651	3995	4339	4704	5084	5481

TABLE 1.2 NOMINAL GNP (Percent change, calendar years)

	1976	1977	1978	1979	1980	1981	1982
Actual	10.9	11.7	12.8	11.7	8.8	12.2	4.0
1976 Forecast a/	13.5	10.1	11.1	10.7	10.1	10.2	
1977 Forecast b/		11.0	10.7	10.5	10.5	10.3	10.5
1978 Forecast c/			11.0	10.8	10.6	10.5	10.6
1979 Forecast d/				11.6	10.4	11.5	11.6
1980 Forecast e/					7.9	11.5	12.7
1981 Forecast f/						11.9	12.3
1982 Forecast g/							7.5
1983 Forecast h/							
1984 Forecast i/							

	1983	1984	1985	1986	1987	1988	1989
Actual	7.7						
1976 Forecast							
1977 Forecast							
1978 Forecast	9.8						
1979 Forecast	11.3	11.0					
1980 Forecast	12.5	12.1	11.8				
1981 Forecast	11.8	11.7	11.2	10.8			
1982 Forecast	11.9	10.4	9.7	9.4	9.1		
1983 Forecast	6.8	9.6	9.0	8.1	7.6	7.4	
1984 Forecast		10.3	9.4	8.6	8.4	8.1	7.8

TABLE 1.3 REAL GNP (Percent change, calendar years)

	1976	1977	1978	1979	1980	1981	1982
Actual	5.4	5.5	5.0	2.8	-0.3	2.6	-1.9
1976 Forecast a/	6.4	3.9	4.8	5.0	4.9	4.9	
1977 Forecast b/		5.4	5.6	5.5	5.3	4.7	4.5
1978 Forecast c/			4.8	4.7	4.8	4.8	4.7
1979 Forecast d/				3.1	2.4	4.3	4.5
1980 Forecast e/					-0.9	2.0	3.4
1981 Forecast f/						1.4	2.9
1982 Forecast g/							-0.1
1983 Forecast h/							
1984 Forecast i/							

	1983	1984	1985	1986	1987	1988	1989
Actual	3.3						
1976 Forecast							
1977 Forecast							
1978 Forecast	3.7						
1979 Forecast	4.5	4.5					
1980 Forecast	3.8	3.8	3.8				
1981 Forecast	2.9	3.3	3.4	3.5			
1982 Forecast	4.4	3.6	3.5	3.5	3.5		
1983 Forecast	2.1	4.7	4.1	3.7	3.5	3.5	
1984 Forecast		5.4	4.1	3.5	3.5	3.4	3.3

TABLE 1.4 GNP DEFLATOR (Percent change, calendar years)

	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Actual	5.2	5.8	7.4	8.6	9.2	9.4	6.0	4.2						
1976 Forecast a/	6.7	6.1	6.0	5.5	5.0	5.0	5.8							
1977 Forecast b/		--	--	--	--	--	--							
1978 Forecast c/			--	--	--	--	--	--						
1979 Forecast d/				8.2	7.7	7.0	6.7	6.5	6.1					
1980 Forecast e/					8.9	9.3	9.0	8.4	8.0	7.7				
1981 Forecast f/						10.3	9.2	8.6	8.1	7.6	7.1			
1982 Forecast g/							7.5	7.3	6.6	6.0	5.7	5.4		
1983 Forecast h/								4.6	4.7	4.7	4.3	3.9	3.8	
1984 Forecast i/									4.7	5.1	4.9	4.7	4.5	4.3

TABLE 1.5 CPI-U (Percent change, calendar years)

	1976	1977	1978	1979	1980	1981	1982
Actual	5.8	6.5	7.7	11.3	13.5	10.4	6.1
1976 Forecast a/	7.2	6.9	5.9	5.6	4.8	5.0	
1977 Forecast b/		5.0	4.8	4.8	5.0	5.3	5.8
1978 Forecast c/			5.6	6.0	5.7	5.5	5.7
1979 Forecast d/				8.4	7.8	7.1	6.7
1980 Forecast e/					11.3	8.9	9.2
1981 Forecast f/						11.3	9.5
1982 Forecast g/							7.5
1983 Forecast h/							
1984 Forecast i/							

	1983	1984	1985	1986	1987	1988	1989
Actual	3.2						
1976 Forecast							
1977 Forecast							
1978 Forecast	5.9						
1979 Forecast	6.4	6.0					
1980 Forecast	8.4	8.0	7.7				
1981 Forecast	9.0	8.3	7.7	7.2			
1982 Forecast	6.9	6.9	6.4	6.0	5.7		
1983 Forecast	4.5	5.0	4.7	4.1	3.9	3.7	
1984 Forecast		4.8	5.1	4.9	4.7	4.5	4.3

TABLE 1.6 CIVILIAN UNEMPLOYMENT RATE (Percent)

	1976	1977	1978	1979	1980	1981	1982
Actual	7.7	7.1	6.1	5.8	7.1	7.6	9.7
1976 Forecast a/	7.7	7.5	7.1	6.7	6.3	5.9	
1977 Forecast b/		6.8	5.9	5.3	4.8	4.4	4.1
1978 Forecast c/			6.5	6.2	5.7	5.2	4.7
1979 Forecast d/				6.2	6.8	6.6	6.2
1980 Forecast e/					7.0	8.0	7.7
1981 Forecast f/						7.7	7.6
1982 Forecast g/							8.9
1983 Forecast h/							
1984 Forecast i/							

	1983	1984	1985	1986	1987	1988	1989
Actual	9.6						
1976 Forecast							
1977 Forecast							
1978 Forecast	4.5						
1979 Forecast	5.9	5.5					
1980 Forecast	7.1	6.4	6.0				
1981 Forecast	7.5	7.4	7.2	7.0			
1982 Forecast	8.0	7.4	7.2	6.9	6.7		
1983 Forecast	10.6	9.8	9.0	8.4	8.0	7.5	
1984 Forecast		7.8	7.3	7.0	6.8	6.6	6.5

DATA SOURCES AND NOTES FOR TABLE 1

a/ Five-Year Budget Projections, Fiscal Years 1977-81, January 26, 1976. 5 percent real GNP growth alternative used.

b/ Five-Year Budget Projections: Fiscal Years 1978-1982, December 1976. The baseline assumptions are consistent with the long-range economic assumptions used by both Committees on the Budget for the Second Concurrent Resolution on the 1977 Budget.

c/ Five-Year Budget Projections: Fiscal Years 1979-1983, December 1977. The assumptions represent extrapolations of the economic assumptions appearing in the conference report on the second concurrent resolution for 1978.

d/ Five-Year Budget Projections and Alternative Budgetary Strategies for Fiscal Years 1980-1984, Janaury 1979.

e/ Five-Year Budget Projections: Fiscal Years 1981-1985, February 1980.

f/ Economic Policy and the Outlook for the Economy, March 1981.

g/ Baseline Budget Projections for Fiscal Years 1983-1987, February 1982.

h/ Baseline Budget Projections for Fiscal Years 1984-1988, February 1983.

i/ Baseline Budget Projections for Fiscal Years 1985-1989, February 1984.

Budget Projections.—Table 2 (in three parts) summarizes CBO's baseline projections of revenues, outlays, and the unified budget deficit, and the actual amounts. The baseline projections and the outturns are not strictly comparable, however, because the former are based on policies in place at the time the projections are made, while the latter reflect many subsequent changes in policies. The baseline projections are also not directly comparable to the estimates contained in Congressional budget resolutions, since actual policies rarely conform exactly to those of the resolution. (Baseline budget projections as a percent of GNP are not available for all years.)

In the baseline projections for 1981 and earlier years, as noted above, revenues grew faster than outlays, and the budget began to show a surplus within two or three years. Projected revenues grew more rapidly than the economy, because inflation and economic growth pushed individuals into higher income tax brackets. Projected baseline outlays, on the other hand, grew more slowly than the gross national product, because most spending was assumed merely to keep pace with inflation. Periodically, however, the Congress would enact discretionary tax cuts, which would prevent taxes from rising as fast as projected in the baseline. Also, the Congress would often provide from some real growth in discretionary spending programs.

The baseline projections made in 1982 and later years are quite different from the earlier projections. Because of the indexing of the individual income tax for inflation, baseline revenues now grow only slightly more rapidly than GNP. Baseline outlays also grow at about the same rate as GNP because of assumed real growth in defense spending, as assumed in recent Congressional budget resolutions. Therefore, recent baseline budget projections are marked by large and growing deficits. But the Congress may well take action to prevent these future deficits from occurring, just as Congressional action assured that the surpluses projected in earlier years did not take place.

Tax expenditure estimates.—The tax expenditure estimates shown in Table 3 are made once a year in the Joint Committee on Taxation, and are based on CBO's January economic forecast. The estimates represent the simple sum of all tax expenditure provisions and, therefore, do not account for interactions that might seriously affect their aggregate revenue-loss. Also, the estimates may not be consistent over time, as several tax expenditure provisions have been added to or dropped from the annual listing.

TABLE 2.1 FEDERAL GOVERNMENT REVENUES (Fiscal Years, Billions of Dollars)

	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Actual	298.1	355.6	399.6	463.3	517.1	599.3	617.8	600.6						
1976 Baseline Projection a/	301	360	401	448	497	550								
1977 Baseline Projection b/		362	407	464	526	594	668							
1978 Baseline Projection c/			397	457	519	590	668	751						
1979 Baseline Projection d/				453	502	574	661	749	849					
1980 Baseline Projection e/					516	582	678	781	905	1053				
1981 Baseline Projection f/						612	709	810	920	1033	1159			
1982 Baseline Projection g/							631	652	701	763	818	882		
1983 Baseline Projection h/								606	653	715	768	822	878	
1984 Baseline Projection i/									663	733	795	863	945	1016

TABLE 2.2 FEDERAL GOVERNMENT OUTLAYS (Fiscal Years, Billions of Dollars)

	1976	1977	1978	1979	1980	1981	1982
Actual	364.5	400.5	448.4	491.0	576.7	657.2	728.4
1976 Baseline Projection a/	375	425	464	495	530	563	
1977 Baseline Projection b/		413	451	480	514	548	586
1978 Baseline Projection c/			458	495	529	565	606
1979 Baseline Projection d/				494	551	604	655
1980 Baseline Projection e/					560	619	686
1981 Baseline Projection f/						660	739
1982 Baseline Projection g/							740
1983 Baseline Projection h/							
1984 Baseline Projection i/							

	1983	1984	1985	1986	1987	1988	1989
Actual	796.0						
1976 Baseline Projection							
1977 Baseline Projection							
1978 Baseline Projection	655						
1979 Baseline Projection	706	755					
1980 Baseline Projection	747	807	875				
1981 Baseline Projection	792	843	895	950			
1982 Baseline Projection	809	889	971	1052	1130		
1983 Baseline Projection	800	850	929	999	1072	1145	
1984 Baseline Projection		853	928	1012	1112	1227	1342

TABLE 2.3 FEDERAL BUDGET SURPLUS (+) OR DEFICIT (-)
(By fiscal year, in billions of dollars)

	1976	1977	1978	1979	1980	1981	1982
Actual	-66.4	-44.9	-48.8	-27.7	-59.6	-57.9	-110.6
1976 Baseline Projection a/	-74	-65	-63	-47	-33	-13	
1977 Baseline Projection b/		-51	-44	-16	12	46	82
1978 Baseline Projection c/			-61	-38	-10	25	62
1979 Baseline Projection d/				-40	-49	-30	6
1980 Baseline Projection e/					-44	-37	-8
1981 Baseline Projection f/						-48	-30
1982 Baseline Projection g/							-109
1983 Baseline Projection h/							
1984 Baseline Projection i/							

	1983	1984	1985	1986	1987	1988	1989
Actual	-195.4						
1976 Baseline Projection							
1977 Baseline Projection							
1978 Baseline Projection	96						
1979 Baseline Projection	43	94					
1980 Baseline Projection	34	98	178				
1981 Baseline Projection	18	76	138	209			
1982 Baseline Projection	-157	-188	-208	-234	-248		
1983 Baseline Projection	-194	-197	-214	-231	-250	-267	
1984 Baseline Projection		-190	-195	-217	-248	-282	-326

a/ Five-Year Budget Projections Fiscal Years 1977-81, January 26, 1976.

b/ Five-Year Budget Projections Fiscal Years 1978-82, December 1976.

c/ Five-Year Budget Projections Fiscal Years 1979-83, December 1977.

d/ Five-Year Budget Projections and Alternative Budgetary Strategies for Fiscal Years 1980-84, January 1979.

e/ Five-Year Budget Projections Fiscal Years 1981-85, February 1980.

f/ Baseline Budget Projections Fiscal Years 1982-86, July 1981.

g/ Baseline Budget Projections for Fiscal Years 1983-87, February 1982.

h/ Baseline Budget Projections for Fiscal Years 1984-88, February 1983.

i/ Baseline Budget Projections for Fisal Years 1985-89, February 1984.

TABLE 3. TAX EXPENDITURE ESTIMATES, 1976 TO 1988 (In billions of dollars)

Date of Estimate	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
1976	98.4	105.9	115.5	125.3	136.1	148.0							
1977		114.2	124.7	134.1	146.5	157.7	168.7						
1978			124.8	136.4	146.8	159.4	171.5	187.7					
1979				150.1	168.8	191.2	214.9	240.6	269.0				
1980					181.5	206.3	233.6	265.0	302.0	345.2			
1981						228.6	266.3	306.4	350.5	403.7	465.3		
1982							253.5	273.1	306.0	347.8	396.0	439.4	
1983								295.3	327.3	369.3	411.6	446.7	490.9

Question: Dr. Penner, your estimated baseline deficit of $326 billion by 1989 assumes that defense spending grows annually at about a 5% real rate between now and then. The President's FY 85 budget assumes much higher defense spending than 5% real growth. What would your estimate of the deficit be if such higher defense spending were enacted? Assuming these defense levels could you give us some idea of the amount of domestic spending cuts or tax increases which would be required in order to reduce the deficit from the figures you just gave to $100 billion a year by 1989?

Answer: In its Analysis of the President's Budgetary Proposals for Fiscal Year 1985, CBO updated its baseline deficit projections. The changes reflect additional technical information gleaned from the Administration's budget, which was not available when the previous projections were prepared, as well as a reduction in the estimated rate of inflation in the defense sector of the economy. The following table compares deficit projections using (1) the revised CBO baseline and (2) the CBO baseline with the President's defense request reestimated by CBO.

TABLE 1. FEDERAL BUDGET DEFICIT (By fiscal year, in billions of dollars)

	1984	1985	1986	1987	1988	1989
CBO Baseline	189	197	217	245	272	308
CBO Baseline with Administration Defense Request as Estimated by CBO	189	208	240	274	299	329

Assuming the Administration's defense request, it would be necessary to reduce nondefense spending or increase taxes by $229 billion in 1989 to reduce the 1989 deficit to $100 billion.

Q. Dr. Penner, your report indicates that interest payments and defense are two of the fastest growing areas of the budget in relation to GNP. How fast are so-called tax expenditures growing in relation to GNP? What types of corporate subsidies are included as tax expenditures?

A. Table 1 shows the total of all tax expenditures for fiscal years 1983 through 1988, as estimated by the Joint Commitee on Taxation (JCT). The totals are broken down between corporate and individual tax expenditures, and both are expressed as a percentage of GNP. One should note that because of interaction among the tax expenditures, the totals presented in the table are only crude estimates of the aggregate revenue-loss effect of tax expenditures on the federal budget. The CBO/JCT estimates of each tax expenditure provision are shown in the CBO report, Tax Expenditures: Current Issues and Five-Year Budget Projections for Fiscal Years 1984-1988. These estimates are based on the January 1983 CBO economic forecast and do not take into account economic (or tax law) changes since then.

In 1983, the sum of all tax expenditures was an estimated $295 billion, or 9 percent of GNP. It is projected that the sum will rise to $491 billion in 1988, or 10 percent of GNP. Over the 1983 to 1988 period the total of tax expenditures is expected to grow at an average annual rate of 10.7 percent versus 8.4 percent for GNP. The sum of tax expenditures for individuals in 1983 is an estimated $239 billion (7.3 percent of GNP) and is forecasted to grow at an average annual rate of 11.1 percent. Over the 1983 to 1988 period total corporate tax expenditures are expected to grow an average annual rate of 9 percent.

Table 2 shows the 20 tax expenditures with the largest revenue losses. The table also includes the average annual growth rate for each tax expenditure. The largest revenue loss is estimated for the exclusion from taxable income of pension contributions and earnings from employer-provided plans. This tax expenditure is projected to increase at an average annual rate of 17 percent over the 1983-1988 period. Other fast growing tax expenditures shown in the table are the investment tax credit (33 percent), the deduction for two-earner married couples (20 percent), and the exclusion of interest on state and local industrial development bonds (15 percent). These compare to an estimated annual GNP growth rate of about 8 percent. Although the provisions shown here account for only about 20 percent of the provisions listed as tax expenditures, they account for about 80 percent of the total revenue loss each year shown in Table 1.

Table 3 provides a listing of tax expenditure provisions that apply to businesses. The revenue losses are those allocated to corporate businesses and to individual businesses (partnerships or sole proprietorships that are taxed at the individual level).

TABLE 1. SUM OF TAX EXPENDITURES BY TYPE OF TAXPAYER, FISCAL YEARS 1983-1988 (in billions of dollars)

Fiscal Year	Total Tax[a] Expenditures	As A Percent of GNP[b]	Individual[a] Tax Expenditures	As A Percent of GNP[b]	Corporate[a] Tax Expenditures	As A Percent of GNP[b]
1983	295.3	9.0	239.1	7.3	56.2	1.7
1984	327.5	9.2	259.5	7.3	67.9	1.9
1985	369.3	9.5	291.9	7.5	77.5	2.0
1986	411.6	9.8	328.4	7.8	83.2	2.0
1987	446.7	9.8	362.1	8.0	84.6	1.9
1988	490.9	10.0	404.4	8.3	86.5	1.8
Average Annual Growth	10.7 percent		11.1 percent		9.0 percent	

SOURCE: Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 1983-1988 (March 7, 1983), p. 18.

a. These totals represent the mathematical sum of the estimated fiscal year effect of each tax expenditure listed in the JCT report. Totals due not account for interactions among tax expenditures that might seriously affect their overall net revenue loss. Therefore, the totals are only crude estimates of the aggregate revenue loss caused by the tax expenditures.

b. GNP is the level forecasted by CBO in January 1983. This is the level consistent with the tax expenditure estimates.

TABLE 2. REVENUE LOSS ESTIMATES FOR THE 20 LARGEST TAX EXPENDITURES (in billions of dollars)

	1983	1984	1985	1986	1987	1988	Average Annual Growth Rate 1983-1988 (Percent)
Net Exclusion of Pension Contributions and Earnings Employer Plans	49.7	56.6	66.4	78.3	92.4	109.4	17.1
Deductibility of Mortgage Interest on Owner-Occupied Homes	25.1	27.9	30.1	32.8	35.3	38.0	8.6
Deductibility of Non-Business State and Local Government Taxes Other Than Owner-Occupied Homes	20.1	21.8	26.6	30.0	34.1	39.0	14.2
Exclusion of Employer Contributions for Medical Insurance Premiums and Medical Care	18.6	21.3	24.3	27.7	31.6	36.0	14.1
Capital Gains Other Than Agriculture, Timber, Iron Ore, and Coal	16.7	16.4	17.5	18.7	20.1	21.5	5.2
Exclusion of Social Security Benefits: OASI Benefits for Retired Workers	15.7	16.7	18.1	19.6	21.3	23.0	7.9
Accelerated Depreciation on Equipment Other Than Leased Property	10.5	18.3	21.7	20.3	16.4	15.8	8.5
Exclusion of Interest on General Purpose State and Local Government Debt	10.4	11.7	13.0	14.2	15.5	16.9	10.2
Deductibility of Property Tax on Owner-Occupied Homes	8.8	9.5	10.5	11.7	13.2	15.0	11.3

(Continued)

TABLE 2. Continued

	1983	1984	1985	1986	1987	1988	Average Annual Growth Rate 1983-1988 (Percent)
Deductibility on Non-Mortgage Interest in Excess of Investment Income	7.7	8.2	8.8	9.6	10.6	11.6	8.5
Investment Credit, Other Than ESOPs, Rehabilitation of Structures, Reforestation, and Leasing	6.7	15.7	19.7	23.8	25.9	27.4	32.5
Deductibility of Charitable Contributions, Other Than Education and Health	7.1	7.2	8.4	10.5	9.6	9.0	4.9
Reduced Rates on the First $100,000 of Corporate Income	5.7	6.5	7.0	8.0	8.8	9.1	9.8
Exclusion of Interest on Life Insurance Savings	4.8	5.2	5.8	6.6	7.6	8.7	12.6
Deferral of Capital Gains on Home Sales	3.8	4.9	5.6	6.0	6.5	7.0	13.0
Exclusion of Social Security Benefits: Benefits for Dependents and Survivors	3.8	3.9	4.1	4.4	4.6	4.9	5.2
Capital Gains at Death	4.0	3.6	3.7	3.9	4.2	4.5	2.4
Deduction for Two-Earner Married Couples	3.4	5.8	6.4	6.9	7.6	8.5	20.1
Deductibility of Medical Expenses	3.1	2.6	3.1	3.4	3.7	4.2	6.3
Exclusion of Interest on State and Local Government Industrial Development Bonds	2.9	3.4	4.1	4.9	5.6	5.9	15.3

SOURCE: Joint Committee on Taxation, Estimates of Federal Tax Expenditures 1983-1984 (March 7, 1983), Table 1.

TABLE 3. TAX EXPENDITURES RELATED TO BUSINESSES

Category	Corporations						Individuals					
	1983	1984	1985	1986	1987	1988	1983	1984	1985	1986	1987	1988
TAX EXPENDITURES RELATED TO BUSINESS (BOTH CORPORATE AND NONCORPORATE)												
Deferral of income of Domestic International Sales Corporations (DISCs)	1,390	1,185	1,075	1,050	1,075	1,110	---	---	---	---	---	---
Deferral of income of controlled foreign corporations	430	345	375	390	420	455	---	---	---	---	---	---
Expensing of research and development expenditures	2,165	2,370	2,360	2,425	2,485	2,535	105	120	125	125	130	135
Credit for increasing research activities	615	650	660	305	65	25	30	35	40	30	5	a
Suspension of regulations relating to allocation under section 861 of research and experimental expenditures	120	60	a	---	---	---	---	---	---	---	---	---
Expensing of exploration and development costs												
Oil and gas	660	440	590	740	835	895	875	800	815	855	900	950
Other fuels	30	30	35	35	40	40	---	---	---	---	---	---
Excess of percentage over cost depletion												
Oil and gas	375	430	445	465	510	555	1,425	1,275	1,305	1,410	1,505	1,625
Other fuels	325	350	355	380	410	440	15	15	15	15	15	20
Capital gains treatment of royalties from coal	35	40	40	45	50	55	140	145	160	175	190	205
Alternative fuel production credit	5	20	25	40	105	285	---	---	---	---	---	---
Alcohol fuel credit[b]	5	5	5	5	5	5	---	---	---	---	---	---
Alternative conservation and new technology credits												
Supply incentives	215	200	175	100	35	20	10	10	5	---	---	---

(Continued)

TABLE 3. (Continued)

Category	Corporations 1983	1984	1985	1986	1987	1988	Individuals 1983	1984	1985	1986	1987	1988
TAX EXPENDITURES RELATED TO BUSINESS (BOTH CORPORATE AND NONCORPORATE)(Continued)												
Alternative conservation and new technology credits												
Conservation incentives	135	35	15	5	a	---	a	a	a	---	---	---
Energy credit for intercity buses	5	5	5	a	---	---	---	---	---	---	---	---
Capital gains treatment of certain timber income	275	390	430	500	575	595	95	125	150	175	205	230
Investment credit and seven-year amortization for reforestation expenditures	a	a	a	a	a	a	10	10	10	10	10	10
Tax incentives for preservation of historic structures	65	90	110	140	185	240	130	165	215	275	355	460
Exclusion of payments in aid of construction of water, sewage, gas and electric utilities	45	75	75	30	75	70	---	---	---	---	---	---
Expensing of exploration and development costs, nonfuel minerals	55	60	65	75	80	85	a	a	a	a	a	a
Excess of percentage over cost depletion, nonfuel minerals	270	295	310	335	355	380	10	10	15	15	15	15
Capital gains treatment of iron ore	5	5	5	5	5	10	5	5	5	5	5	10
Expensing of certain capital outlays	85	90	95	100	100	105	475	495	510	530	545	565
Capital gains treatment of certain income	30	35	35	40	40	45	455	475	500	530	545	565
Deductibility of patronage dividends and certain other items of cooperatives	950	980	1,010	1,040	1,075	1,110	-390	-400	-410	-425	-435	-450
Exclusion of certain cost-sharing payments	---	---	---	---	---	---	50	45	40	30	25	25
Excess bad debt reserves of financial institutions	335	575	785	930	1,060	1,030	---	---	---	---	---	---

(Continued)

TABLE 3. (Continued)

Category	Corporations						Individuals					
	1983	1984	1985	1986	1987	1988	1983	1984	1985	1986	1987	1988
TAX EXPENDITURES RELATED TO BUSINESS (BOTH CORPORATE AND NONCORPORATE)(Continued)												
Exemption of credit union income	170	185	200	220	240	260	---	---	---	---	---	---
Depreciation on rental housing in excess of straight-line	120	155	165	170	180	185	575	665	720	760	795	820
Depreciation on buildings (other than rental housing) in excess of straight-line	175	200	215	240	265	295	150	165	185	210	230	250
Reinvestment of dividends in stock of public utilities	---	---	---	---	---	---	365	415	450	230	---	---
Accelerated depreciation on equipment other than leased property	9,510	15,865	18,860	17,445	14,110	13,890	1,015	2,460	2,845	2,825	2,255	1,915
Safe-harbor leasing:												
Accelerated depreciation and deferral	1,745	1,885	1,635	1,285	1,040	525	---	---	---	---	---	---
Investment credit	1,625	915	705	710	515	280	---	---	---	---	---	---
Amortization of business start-up costs	15	20	25	30	35	40	105	160	230	285	315	355
Capital gains other than agriculture, timber, iron ore, and coal	1,770	2,075	2,130	2,305	2,475	2,695	14,955	14,320	15,365	16,440	17,590	18,820
Reduced rates on the first $100,000 of corporate income	5,690	6,525	7,025	8,060	8,765	9,090	---	---	---	---	---	---
Investment credit, other than for Employee Stock Ownership Plans (ESOPs), rehabilitation of structures, reforestation and leasing	9,965	12,315	16,075	19,870	21,650	22,860	3,220	3,350	3,615	3,945	4,245	4,595
Amortization of motor-carrier operating rights	70	70	50	15	5	a	5	5	5	5	a	---
Deferral of tax on shipping companies	30	40	40	45	45	45	---	---	---	---	---	---

(Continued)

TABLE 3. (Continued)

Category	Corporations						Individuals					
	1983	1984	1985	1986	1987	1988	1983	1984	1985	1986	1987	1988
TAX EXPENDITURES RELATED TO BUSINESS (BOTH CORPORATE AND NONCORPORATE)(Continued)												
Five-year amortization for housing rehabilitation	20	25	25	25	25	25	30	35	35	35	35	35
Investment credit for rehabilitation of structures other than historic structures	175	200	185	195	215	235	160	165	160	165	180	200
Targeted jobs credit	215	395	355	155	30	5	75	70	30	a	---	---
Tax credit for Employee Stock Ownership Plans (ESOPs)	1,250	1,375	1,875	2,235	2,330	950	---	---	---	---	---	---
Tax credit for orphan drug research	10	15	15	10	---	---	---	---	---	---	---	---
Tax credit for corporations receiving income from doing business in United States possessions	1,350	1,075	1,135	1,240	1,375	1,525	---	---	---	---	---	---
TAX EXPENDITURES RELATED TO BOTH INDIVIDUALS AND BUSINESSES												
Exclusion of interest on state and local government student loan bonds	150	200	260	320	390	460	70	100	125	155	190	225
Deductibility of charitable contributions (education)	280	345	360	415	480	525	495	495	580	735	660	615
Deductibility of charitable contributions, other than education and health	350	425	445	515	590	645	6,795	6,765	7,930	10,030	9,030	8,370
Exclusion of interest on state and local government hospital bonds	795	960	1,115	1,265	1,420	1,580	385	470	545	625	700	780
Deductibility of charitable contributions (health)	175	215	225	255	295	325	995	990	1,160	1,470	1,320	1,225
Exclusion of interest on general purpose state and local debt	6,985	7,850	8,695	9,530	10,370	11,280	3,435	3,870	4,295	4,715	5,130	5,580

(Continued)

TABLE 3. (Continued)

Category	Corporations						Individuals					
	1983	1984	1985	1986	1987	1988	1983	1984	1985	1986	1987	1988
TAX EXPENDITURES RELATED TO BOTH INDIVIDUALS AND BUINESSES (Continued)												
Exclusion of interest on state and local government industrial development bonds for energy production facilities	15	20	30	40	55	70	5	10	15	20	20	25
Exclusion of interest on state and local government pollution control bonds	900	1,025	1,140	1,255	1,375	1,510	440	505	565	620	680	745
Exclusion of interest on state and local government housing bonds for owner-occupied housing	1,060	1,190	1,190	1,145	1,105	1,070	450	485	475	445	415	385
Exclusion of interest on state and local government housing bonds for rental housing	585	735	880	1,035	1,185	1,345	285	355	430	510	585	665
Exclusion of interest on state and local industrial development bonds	2,353	2,790	3,265	3,875	4,385	4,615	570	675	800	985	1,180	1,310
Exclusion of interest on state and local government mass transit bonds	45	65	75	75	65	75	15	25	20	15	10	20

a. Less than $2.5 million.

b. In addition, the exemption from the excise tax for alcohol fuels results in a reduction in excise tax receipts, net of the income tax effect, of approximately $40 million 1983, $60 million for 1984, $80 million for 1985, $95 million for 1986, and $110 million for 1987 and 1988.

Question: Dr. Penner, could you tell us the change in the percentage of GNP which is assumed in your baseline between 1984 and 1989, for entitlement programs, other than Medicare and Medicaid? Why are entitlements, in particular Social Security, growing less rapidly than GNP? How does the declining percentage for these entitlements compare with changes in GNP shares for defense and net interest between 1984 and 1989?

Answer: In our baseline projections entitlements other than Medicare and Medicaid shrink from 8.8 percent to 7.7 percent of GNP between 1984 and 1989. Social security benefits, which represent more than half of this category, decline from 4.9 percent to 4.6 percent of gross national product because benefits of current recipients are indexed to prices and because projected caseload growth is less than the growth in real GNP. Spending for unemployment compensation and for means-tested programs other than Medicaid declines from 1.7 percent to 1.2 percent of GNP, largely because of the projected fall in the unemployment rate. For a variety of reasons other entitlements also decline slightly as a share of GNP.

In comparison, baseline defense outlays grow from 6.6 percent of GNP in 1984 to 7.6 percent of GNP in 1989, assuming roughly 5 percent annual real growth in defense budget authority. Net interest outlays grow from 3.1 percent of GNP to 4.0 percent of GNP over the same period.

Question: Dr. Penner, as I noted in my opening statement, I was pretty shocked by your table which shows that legislative actions of the last three years will increase net interest costs by $100 a year by 1989. If no further changes are made in spending or revenues, how much will be spending on net interest in 1989? How does this compare with the retirement and survivors portion of Social Security (OASI) in that year? How did these two expenditures compare in 1981?

Answer: In 1981, outlays for Social Security ~~retirement~~ Old Age and Survivors Insurance (OASI) were $139 billion. The CBO projects that OASI outlays will be $228 billion in 1989 if there is no further legislation affecting this portion of Social Security.

Net interest outlays in 1981 were $69 billion. Without any further legislative action, the CBO estimates that net interest outlays will be $216 billion in 1989.

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